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RETHINKING PROCEEDS: THE HISTORY, MISINTERPRETATION AND REVISION OF U.C.C. SECTION 9-306

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I. INTRODUCTION

On its face, the Uniform Commercial Code (U.C.C.) attempts to provide a straightforward rule governing the rights of the debtor and the secured party when the debtor disposes of some or all of the secured party's collateral. Under U.C.C. section 9-306, the secured party not only maintains its security interest in the collateral following disposition, but also obtains a security interest in any identifiable proceeds of the collateral.¹ Within the definition of "proceeds," the U.C.C. includes anything received upon the "sale, exchange, collection or other disposition of" the collateral.² This continuing proceeds coverage is a default rule; under Section 9-203(3), the secured party automatically obtains continuing coverage against proceeds unless the security agreement specifies otherwise.³ Through these provisions, the U.C.C. seeks to achieve efficiency in secured transactions by codifying the *ex ante* bargain of the hypothetical reasonable debtor and secured party, who would expect the secured party's lien to continue against whatever property the debtor receives upon disposition of the collateral.⁴

Despite the drafters' functional scheme, however, judicial interpretation of Section 9-306(1)'s proceeds coverage has been anything but straightforward. During the thirty-plus years following the adoption of Article 9, opportunistic debtors and bankruptcy

1. U.C.C. § 9-306(2) (1990) ("Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.").

2. *Id.* § 9-306(1).

3. *Id.* § 9-203(3).

4. As Professor Hawkland has stated:

[The U.C.C.] automatically gives the parties a right to collateral (proceeds) that is usually bargained for even in those cases in which the parties have forgotten to implement their bargain by appropriate language in the security agreement. In the unusual case in which the parties do not want proceeds included as part of the collateral, they have the option of excluding it Efficiency is promoted . . . because the parties must act affirmatively only in unusual cases

William D. Hawkland, *The Proposed Amendments to Article 9 of the U.C.C. Part II: Proceeds*, 77 COM. L.J. 12, 16 (1972); see also REVIEW COMMITTEE FOR ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE, PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, FINAL REPORT 63 (1971) ("[C]laims to proceeds under Section 9-306 do not require a statement in the security agreement, for it is assumed that the parties so intend unless otherwise agreed." (emphasis added)).

trustees, eager to find unencumbered funds to finance a reorganization or to pay administrative expenses, have urged courts to construe Section 9-306(1)'s definition of proceeds narrowly. Debtors and bankruptcy trustees have raised this interpretive issue in a variety of contexts, as shown by the following examples:

- Debtor owns a car subject to a security interest in favor of Secured Party. Following Debtor's bankruptcy, the car is destroyed by an insured casualty. Upon receiving the insurance moneys, Trustee argues that Secured Party has no lien upon those funds because there has been no sale, exchange, collection, or other disposition of the car.⁵
- Debtor owns a machine subject to a security interest in favor of Secured Party. Prior to filing for bankruptcy, Debtor had leased the machine to Lessee for \$500 per month. During bankruptcy, Debtor argues that the lease rentals do not constitute Secured Party's cash collateral because there has been no sale, exchange, collection, or other disposition of the machine.⁶
- Debtor owns 500 shares of stock in ABC Company, subject to a security interest in favor of Secured Party. Following Debtor's bankruptcy, ABC Co. pays a cash dividend of \$1 per share. Trustee seeks to use the cash dividend to pay administrative expenses, arguing that the funds do not constitute Secured Party's cash collateral because there has been no disposition of the stock.⁷
- Debtor borrows \$10,000 from Secured Party and grants Secured Party a security interest in its upcoming corn crop. Instead of planting the crop, Debtor signs a payment-in-kind (PIK) contract and receives a government subsidy, in the form of PIK certificates, for agreeing not to plant corn. After Debtor's bankruptcy, Trustee argues that the PIK certificates are unencumbered because they are not proceeds of Debtor's crops, since there was no disposition of Debtor's crops.⁸

In each of these examples, the disputed asset represents a return of the economic value or productive capacity of the bargained-for collateral. Thus, in each case Secured Party can argue persuasively that the Debtor received the disputed funds upon a disposition of collateral within the meaning of Section 9-306(1).⁹ Nevertheless, because the language of Section 9-306(1) is not perfectly suited to this

5. See *infra* part II.B.1.

6. See *infra* part II.B.2.

7. See *infra* notes 20-37 and accompanying text.

8. See *infra* part III.A.1.

9. See U.C.C. § 9-306(1) (1990).

expansive interpretation, many courts have construed it in a narrow, formalistic fashion that severely limits the scope of the term "proceeds." For example, some courts have construed Section 9-306(1) using a "passage of title" conception of proceeds, which refuses to treat an asset as proceeds unless the debtor has permanently disposed of title to the underlying collateral.¹⁰ Under this interpretation, sums such as casualty insurance proceeds and lease rentals would not constitute proceeds of the secured party's collateral when the collateral was damaged or leased.¹¹ In addition, courts have often construed Section 9-306(1) to exclude sums from constituting proceeds when the bargained-for collateral never came into existence.¹² Under this interpretation, which is referred to in this Article as the "nonexistent collateral" problem, sums such as agricultural subsidies paid to a debtor not to plant a particular crop would not constitute proceeds of the crops that the debtor previously pledged to the secured party as collateral.¹³

Not every court has accepted such narrow constructions of Section 9-306; therefore, the judicial debate has yielded a hodgepodge of inconsistent opinions that has prevented the term "proceeds" from acquiring a coherent meaning and scope. In addition to the costs of nonuniformity that arise whenever different courts interpret a statute inconsistently, the lack of a coherent definition of proceeds has impeded the U.C.C.'s ability to implement its underlying policy of facilitating efficiency in commercial transactions. As Professor Thomas Quinn has noted, "[T]he slick language of 9-306 covers so vast an assortment of factually different and complex problems that generalization and simplifications are fraught with peculiar risks."¹⁴

The time is ripe for careful reanalysis of the scope of the term "proceeds" under Section 9-306(1). In 1990, the National Conference of Commissioners on Uniform State Laws (NCCUSL), the American Law Institute (ALI), and the Permanent Editorial Board for the U.C.C. (PEB) established a committee to study whether Article 9 needed

10. See *infra* part II.A.

11. See *infra* part II.B.

12. See *infra* part III.A.

13. See *infra* part III.A.1.

14. 2 THOMAS M. QUINN, QUINN'S UNIFORM COMMERCIAL CODE COMMENTARY AND LAW DIGEST ¶ 9-306[A], at 9-293 (2d ed. 1991).

revision.¹⁵ In late 1992, this study committee issued its report (the *PEB Report*), stating that while Article 9 was conceptually sound, the system of commercial transactions would still benefit from a comprehensive revision.¹⁶ Pursuant to this recommendation, NCCUSL and ALI appointed a drafting committee¹⁷ (the Drafting Committee) that has already begun its work. This revision process provides an ideal opportunity for the Drafting Committee to develop and implement a coherent conception of the term "proceeds" that reflects its proper scope.

This Article provides a careful analysis of the proper scope of the term "proceeds" under Section 9-306. Parts II and III develop a coherent conception of the term "proceeds" by focusing upon the proper interpretation of Section 9-306 in its current form. Part II evaluates the passage of title conception of proceeds in light of the 1972 and 1987 amendments to Article 9 and demonstrates that this conception is fundamentally inconsistent with the economic, value-based conception of proceeds that emerges from those amendments. Using this emerging conception of proceeds, which focuses upon the occurrence of an event that exhausts or consumes the collateral's economic value or productive capacity, Part II demonstrates the correct interpretation of Section 9-306(1) in cases involving casualty insurance proceeds, lease rentals, stock dividends, and tort settlements. In Part III, the Article examines the nonexistent collateral problem and demonstrates that it is a formalistic, outmoded concept that both frustrates the *ex ante* bargain of the reasonable debtor and secured party and fails to give effect to the emerging value-based conception of the term "proceeds." Part III further demonstrates the correct interpretation of the current Section 9-306(1) in cases involving government agricultural subsidy payments and business interruption insurance payments.

In Part IV, the Article shifts its focus toward the need to revise Section 9-306 to express a clear, coherent definition of proceeds that is consistent with the emerging value-based conception of that term. Part IV begins by reviewing and evaluating the recommendations of the

15. PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, PEB STUDY GROUP UNIFORM COMMERCIAL CODE ARTICLE 9 at 1 (1992) [hereinafter PEB REPORT].

16. *Id.* at 6.

17. *Id.* at 18.

PEB Report concerning Section 9-306 and the scope of the term “proceeds.” The Article criticizes two specific problems with the *PEB Report’s* recommendations. First, in an attempt to identify the standards for what constitutes proceeds, the *PEB Report* identified two ostensibly different conceptions of proceeds: “exchange and replacement” proceeds and “close association” proceeds. Part IV criticizes this dichotomy, which makes it appear that there is no unifying conception to provide a basis for defining the term “proceeds.” Instead, as Part IV argues, the definition should be based upon one unified conception—that the term “proceeds” includes any asset received as a consequence of some event that consumes a portion of the bargained-for collateral’s economic value or productive capacity.

Second, in an attempt to limit the scope of the term “proceeds,” the *PEB Report* asserted that certain assets were too attenuated to constitute proceeds even though a debtor received them by virtue of events that resulted in a diminution of the collateral’s value.¹⁸ As Part IV demonstrates, this attempted qualification places an incoherent and economically unjustified restraint upon the term “proceeds.” Further, the *PEB Report* confuses the question of whether an asset constitutes proceeds of collateral with the question of whether a security interest continues against that asset. Instead of encouraging courts to place unjustified limitations upon the scope of the term “proceeds,” the Drafting Committee should instead direct courts to focus upon the *identifiability* of proceeds as the key to the secured party’s ability to obtain continuing proceeds coverage under Section 9-306. The Article concludes with an appendix setting forth proposed statutory language and commentary for the Drafting Committee’s consideration as it revises Section 9-306.

18. For example, the study committee asserted that accounts generated by a construction contractor “should not be considered proceeds of the contractor’s construction equipment, even though the equipment depreciates as a result of its use in generating the accounts.” *Id.* at 111 n.16.

II. THE EMERGING TRUE SCOPE OF PROCEEDS AND THE EFFECT OF "PASSAGE OF TITLE"

A. *Judicial Reliance upon Passage of Title as the Key to Classification: An Introduction*

Before classifying an asset as proceeds of collateral, one first must interpret Section 9-306(1)'s definition of proceeds. Most of the terms in that definition are transactional (*e.g.*, "sale," "exchange," and "collection"), and several (*e.g.*, "sale" and "exchange") obviously contemplate a transfer of legal title to the collateral.¹⁹ Accordingly, one might construe Section 9-306(1) as expressing a passage of title conception of proceeds, requiring the debtor to have transferred complete title to the collateral in order to classify an asset as proceeds of the collateral.

In fact, most courts have used this passage of title concept as the key to classification under Section 9-306(1). An excellent example of this approach is the decision of the United States Court of Appeals for the Tenth Circuit in *In re Hastie*.²⁰ In 1981, John Douglas Hastie borrowed \$750,000 from First National Bank and Trust Company of Oklahoma City (First National Bank), to which Hastie granted a security interest in 248 shares of stock of FirstBank Holding Company (FirstBank).²¹ The security agreement provided:

[T]he Debtor hereby sells, assigns, transfers and conveys . . . a Security interest in and to all of the Debtor's interest and property rights, . . . including, without limitation, all moneys and claims for moneys due and to become due to the Debtor under all dividends, distributions, accounts, contract rights, voting rights and general intangibles relating to and/or due from [FirstBank]

....

... The Secured Party will have the right to receive from [FirstBank] the share of dividends, profits, return of contributions and other distributions to which the debtor would be entitled.²²

Subsequently, the Federal Deposit Insurance Corporation (FDIC) succeeded to the interest of First National Bank.²³ While the FDIC

19. See U.C.C. § 9-306(1) (1990).

20. 2 F.3d 1042 (10th Cir. 1993).

21. Brief in Chief of Appellant, Acquisition Management, Inc. at 3, *In re Hastie*, 2 F.3d 1042 (10th Cir. 1993) (No. 92-6034).

22. *Hastie*, 2 F.3d at 1043-44 n.1 (alterations in original).

23. Appellant's Brief at 3, *Hastie* (No. 92-6034).

maintained possession of the stock certificates, thereby perfecting its security interest in the stock under Oklahoma law,²⁴ the FDIC never requested that FirstBank register a change of the stock's ownership.²⁵ Therefore, at all relevant times, Hastie continued to be listed as the registered owner of the FirstBank stock.²⁶

On October 12, 1988, Hastie filed a voluntary Chapter 11 petition.²⁷ During the bankruptcy, FirstBank paid cash dividends on three different occasions, pursuant to which Hastie received a total of \$130,317.91.²⁸ When the FDIC asserted a lien against those dividends under its security agreement, Hastie filed an adversary proceeding seeking a declaration that the FDIC²⁹ had no effective security interest against the dividends. The bankruptcy court granted summary judgment for Hastie, holding that FDIC failed to perfect its security interest in the dividends.³⁰ The district court adopted the bankruptcy court's opinion and affirmed.³¹ On appeal, the FDIC argued that its security interest in the dividends remained unaffected by Hastie's bankruptcy filing, since the dividends constituted proceeds of the stock under Section 9-306(1) and Bankruptcy Code section 552(b).³²

24. See OKLA. STAT. ANN. tit. 12A, § 8-321(1)-(2) (West Supp. 1994); see also *Hastie*, 2 F.3d at 1044.

25. *Hastie*, 2 F.3d at 1044.

26. *Id.*

27. Appellant's Brief at 3, *Hastie* (No. 92-6034).

28. *Id.*

29. During the litigation, Acquisition Management, FDIC's successor in interest with respect to the FirstBank stock, was substituted as a party plaintiff. Appellant's Brief app. at 106, *Hastie* (No. 92-6034). For ease of understanding, however, both the bankruptcy court and the Tenth Circuit continued to identify the FDIC as the secured party in their opinions. See generally *Hastie*, 2 F.3d 1042.

30. *In re Hastie*, No. 90-0230-LN, slip op. at 9 (W.D. Okla. Mar. 29, 1991), reprinted in Appellant's Brief app. at 98, *Hastie* (No. 92-6034). The court stated that:

At any time prior to the filing of debtor's petition herein, FDIC could have caused the record ownership of the [FirstBank] Stock to be transferred to it, thereby assuring under UCC § 8-207(1) that it would receive any notifications or dividends to which the registered owner would be entitled. . . . It did not do so.

Id. (footnote omitted).

31. Appellant's Brief app. at 89, *Hastie* (No. 92-6034).

32. *Hastie*, 2 F.3d at 1044. At the time of the *Hastie* decision, Section 552(b) provided:

[I]f the debtor and [the secured party] entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to *proceeds, product, offspring, rents, or profits of such property*, then such security interest extends to such proceeds, product, offspring, rents, or

The Tenth Circuit rejected the FDIC's argument.³³ In analyzing whether the dividends were proceeds of the FirstBank stock, the court first focused upon the transactional nature of Section 9-306(1)'s definition of the term "proceeds":

With respect to this definition, the term "sale" may be defined generally as "[a] revenue transaction where goods or services are delivered to a customer in return for cash or a contractual obligation to pay. [The] [t]erm comprehends [a] transfer of property from one party to another for valuable recompense." Similarly, the term "exchange" may be defined as "[the] [a]ct of giving or taking one thing for another," and the term "collect" in the context of a debt or claim may be defined as "payment or liquidation of it." Lastly, the phrase "other disposition" may be defined generally as the "[a]ct of disposing; [or] transferring to the care or possession of another; [or] [t]he parting with, alienation of, or giving up [of] property." Accordingly, each of the foregoing events describes an event whereby one asset is disposed of and another is acquired as its substitute.³⁴

Based upon the transactional focus of this definition, the Tenth Circuit extrapolated that characterization of an asset as proceeds required passage of title to the collateral:

The receipt of cash dividends by a registered owner of certificated securities bears no resemblance to the events specified in the definition of proceeds or to an act of disposition generally. . . . [A]lthough the cash dividend distributes assets of the corporation, it does not alter the ownership interest represented by the stock. The cash dividend, therefore, is not a disposition of the stock. Normally, stock is not disposed of, sold, or exchanged in any way unless a change in the ownership interest in the issuing corporation is thereby effected.³⁵

Since Hastie owned 248 shares before and after receipt of the dividends, the Tenth Circuit concluded that the dividends did not

profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law

11 U.S.C. § 552(b) (1988) (emphasis added). Congress recently amended Bankruptcy Code Section 552(b) in Section 214 of the Bankruptcy Reform Act of 1994, H.R. 5116, 140 CONG. REC. H10752 (daily ed. Oct. 4, 1994). For the language of Section 552(b), as amended, see *infra* note 218 and accompanying text.

33. See *Hastie*, 2 F.3d at 1045-57.

34. *Id.* at 1045 (quoting BLACK'S LAW DICTIONARY 1200 (5th ed. 1979)) (citations omitted).

35. *Id.* at 1045-46.

constitute proceeds of the FirstBank stock.³⁶ The Tenth Circuit accordingly held that under Oklahoma law, the FDIC's security interest in the dividends was "not perfected."³⁷

B. Debunking the "Passage of Title" Conception: A History Lesson

The passage of title analysis reflected in *Hastie* and other cases is hopelessly inconsistent with the proper scope of the term "proceeds." One can construct the proper scope of the term "proceeds" by reviewing the actions of the U.C.C. drafters in revising Article 9. On two occasions following the enactment of Article 9, statutory amendments have reinforced the notion that courts should not construe Section 9-306(1) in a formalistic fashion that focuses upon location of title, but in a functional manner that focuses upon whether some event has consumed the economic value or the productive capacity of the collateral. These two amendments—the 1972 revision of Section 9-306(1) involving casualty insurance payments³⁸ and the 1987 revision of Section 1-201(37)³⁹ concerning the distinction between "true" and "security" leases—reflect the emerging economic conception of the term "proceeds."

1. Insurance Payments as Proceeds

When a casualty destroys an item of property, casualty insurance provides a monetary substitute to compensate the property owner for the loss in value occasioned by the casualty. If X totals her car and X's insurer pays her \$15,000 for her loss, X is in a position

36. *See id.*

37. *Id.* at 1045. Technically, the Tenth Circuit's conclusion that the FDIC's security interest in the dividends was unperfected is incorrect. In fact, under the Tenth Circuit's analysis, the FDIC had no continuing security interest in the dividends at all, by virtue of Bankruptcy Code § 552(a). *See* 11 U.S.C. § 552 (1988). Under § 552(a), a prepetition security interest in dividends would not attach to any dividends received by the debtor after the petition date. *See id.* § 552(a). Thus, the FDIC would have no continuing security interest in the postpetition dividends, unless the postpetition dividends were also proceeds of other prepetition collateral. In that case, the FDIC would receive a continuing security interest against the dividends by virtue of § 552(b). *See supra* note 32. Once the Tenth Circuit concluded that the dividends were not proceeds of the FirstBank stock, the Tenth Circuit should have held that the FDIC had no security interest, perfected or otherwise, in the dividends under § 552(a).

38. U.C.C. § 9-306(1) (1972) (current version at U.C.C. § 9-306(1) (1990)).

39. U.C.C. § 1-201(37) (1987) (current version at U.C.C. § 1-201(37) (1990)).

similar to one that she would have occupied had she sold her car to Y for \$15,000 cash, in which case the \$15,000 cash clearly would be proceeds of the car under Section 9-306(1).⁴⁰ Prior to 1972, however, Section 9-306(1) did not explicitly address the issue of whether insurance moneys received upon the destruction of Article 9 collateral constituted proceeds of that collateral.⁴¹ Section 9-306(1)'s silence on this point generated a substantial number of lawsuits involving competing claims to insurance moneys. Secured parties with liens upon damaged collateral argued that insurance moneys were a substitute for the damaged collateral, which had suffered a disposition under Section 9-306(1). Debtors and bankruptcy trustees sought to retain insurance moneys free of secured claims, arguing that since no transfer of title to the collateral had taken place, the insurance payments could not constitute proceeds.

Under the 1962 version of Section 9-306(1), the vast majority of courts addressing this issue concluded that since damaged collateral was not disposed of under Section 9-306(1), insurance moneys were not proceeds of the damaged collateral.⁴² The decision of the Rhode Island Supreme Court in *Universal C.I.T. Credit Corp. v. Prudential Investment Corp.*⁴³ is typical of these decisions. In March 1964, Eugene Tourtellot granted Prudential a security interest in an International tractor in which Mack Financial Corporation (Mack) already claimed a first priority lien.⁴⁴ Tourtellot thereafter traded the

40. See U.C.C. § 9-306(1) (1990).

41. The 1962 version of § 9-306(1) provided:

"Proceeds" includes whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of. The term also includes the account arising when the right to payment is earned under a contract right. Money, checks and the like are "cash proceeds". All other proceeds are "noncash proceeds".

U.C.C. § 9-306(1) (1962) (current version at U.C.C. § 9-306(1) (1990)).

42. See, e.g., *Sanchez v. United States*, 696 F.2d 213, 215-16 (2d Cir. 1982); *In re Whitacre*, 21 U.C.C. Rep. Serv. (Callaghan) 1169, 1174-75 (Bankr. S.D. Ohio 1976); *In re Parks*, 19 U.C.C. Rep. Serv. (Callaghan) 334, 334-35 (Bankr. E.D. Tenn. 1976); *In re Waltman*, 18 U.C.C. Rep. Serv. (Callaghan) 576, 579 (Bankr. S.D. Ala. 1975); *In re Hix*, 9 U.C.C. Rep. Serv. (Callaghan) 925, 927-28 (Bankr. S.D. Ohio 1969); *In re Levine*, 6 U.C.C. Rep. Serv. (Callaghan) 238, 241 (Bankr. D. Conn. 1969); *White v. Household Fin. Corp.*, 302 N.E.2d 828, 836 n.9 (Ill. Ct. App. 1973); *Quigley v. Caron*, 247 A.2d 94, 95-96 (Me. 1968); *Third Nat'l Bank v. Continental Ins. Co.*, 446 N.E.2d 380, 382 (Mass. 1983); *In re Boyd*, 658 P.2d 470, 471-74 (Okla. 1983); *Universal C.I.T. Credit Corp. v. Prudential Inv. Corp.*, 222 A.2d 571, 574-75 (R.I. 1966).

43. 222 A.2d 571.

44. *Id.* at 572.

International tractor toward the purchase of a new Diamond T tractor from United Truck and Bus Service Company (United).⁴⁵ United, which had no knowledge of the outstanding security interests in the International tractor, financed Tourtellot's purchase using a conditional sales contract, which United later assigned to Universal C.I.T. Credit Corp. (CIT).⁴⁶ Tourtellot insured the Diamond T tractor pursuant to a policy listing CIT as loss payee.⁴⁷

Shortly thereafter, Tourtellot had an accident that destroyed the Diamond T tractor.⁴⁸ At this point, United learned that Mack possessed a prior lien on the International tractor and that the Diamond T trailer had been destroyed.⁴⁹ At United's insistence, Tourtellot assigned to United all of his interest in the proceeds of the insurance contract, to the extent of \$6,300.⁵⁰ After Tourtellot's insurance carrier paid \$15,494.25 to CIT under its policy, CIT satisfied its claim and deposited the remaining moneys into court, interpleading Prudential and United.⁵¹ In the ensuing action, Prudential claimed priority in the remaining insurance moneys as proceeds of the Diamond T tractor.⁵²

The Rhode Island Supreme Court established two grounds for rejecting Prudential's argument. First, the court concluded that "[i]nsurance moneys or proceeds flow from the insurance contract and not from the property insured."⁵³ The court stated:

While moneys paid by an insurance carrier to reimburse one for a loss which is covered under the insurance contract are many times referred to as insurance proceeds, they are not proceeds as that term is defined in § 6A-9-306(1).

"Proceeds" by definition under the code arises from either a sale, exchange, collection or other disposition of either the collateral or proceeds. Insurance moneys or proceeds, however, arise and are paid as the result of a contract. An insurance contract or policy, so called, pertains to the persons to the contract and not to the item insured. It is

45. *Id.*

46. *Id.* at 572-73.

47. *Id.*

48. *Id.* at 573.

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* at 575.

a personal contract which does not attach to or run with the property insured.⁵⁴

Instead of relying solely upon this contractual analysis, the court found a second justification for its interpretation of the term "proceeds" as used in Section 9-306(1). Adopting the passage of title conception of proceeds, the court concluded that "the loss here of the 1964 Diamond T was neither a sale, exchange, collection nor such other disposition as to come within the meaning of this section."⁵⁵

Decisions like *Universal C.I.T. Credit Corp.* reflected a triumph of form over function in judicial interpretation of Section 9-306(1). Following a casualty loss, the owner of a damaged item may possess nominal title to that item.⁵⁶ The casualty, however, has irretrievably reduced the utility of that title by an amount equal to the total reduction of the collateral's economic value. The insurance moneys collected following a casualty are a direct substitute for that lost economic value.

If one attempted to hypothesize the *ex ante* bargain of the reasonable debtor and secured party, one would expect them to understand that insurance moneys would stand in the stead of damaged collateral.⁵⁷ Recognizing this, in 1972 the U.C.C. drafters revised Section 9-306(1), overruling decisions like *Universal C.I.T. Credit*

54. *Id.* at 574.

55. *Id.* at 575.

56. However, this is not necessarily the case. If the collateral was a total loss, the insurer might require assignment of title to the collateral in exchange for payment of the claim, or the insurer may become subrogated to the insured's title to the collateral either by the express terms of the policy or under equitable principles. See ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW* § 3.10(a)(1), at 219-20 (practitioner's ed. 1988).

57. 2 QUINN, *supra* note 14, ¶ 9-306[A][11], at 9-309 ("Any sane lender wants the collateral insured, and he wants it for a very obvious reason. He is relying on that collateral, and, if it goes up in smoke, he wants to see the insurance money standing in its place. It's as simple as that . . ."). The Bankruptcy Code's provisions regarding adequate protection and relief from the automatic stay contain further support for this proposition. A bankrupt debtor may not retain and use collateral over the objection of the secured party unless the debtor can provide the secured party with adequate protection of its interest in the collateral. See 11 U.S.C. §§ 361(1)-(3), 362(d)(1), 363(e) (1988). Because failure to insure the collateral would pose a substantial threat to the secured party's interest in case of a casualty, the debtor must at a minimum insure the collateral in order to provide the secured party with adequate protection. See DAVID G. EPSTEIN ET AL., *BANKRUPTCY* § 3-27(b), at 143 (1993). As a normative matter, the Bankruptcy Code's adequate protection provisions capture the expected *ex ante* bargain of the reasonable debtor and secured party that insurance proceeds would stand in the stead of the collateral following a casualty.

Corp. and expressly codifying this expected *ex ante* bargain.⁵⁸ The revision added a sentence to Section 9-306(1), making clear that “[i]nsurance payable by reason of loss or damage to the collateral is proceeds” of the collateral.⁵⁹ The 1972 amendment thus reflects the origin of an economic, value-based conception of proceeds that depends upon whether an asset constitutes a return for some event that extracted economic value from the collateral.⁶⁰

2. Lease Payments as Proceeds

There are several ways in which one can use an item of collateral in operating a business. For example, one can use a machine by selling it to a third party for cash and using that cash to fund operations. In that case, the cash clearly would constitute proceeds of the machine under Section 9-306(1).⁶¹ Alternatively, one could use a machine by leasing it to third parties for their use. One might also characterize the leasing of collateral as a disposition, such that any rents paid by the lessee would constitute proceeds of the collateral.⁶² The lessor grants the lessee exclusive use of the

58. See U.C.C. § 9-306(1) (1990).

59. *Id.* The drafters noted that this sentence was “intended to overrule various cases to the effect that proceeds of insurance on collateral are not proceeds of the collateral.” PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, FINAL REPORT, Section 9-306 Reasons for Change 97-98 (1971) [hereinafter Reasons for Change].

60. At least one court interpreting the 1962 version of § 9-306(2) concluded that the 1972 revision merely expressed what was implicit in the language of the 1962 version:

As the reporter’s commentary to this amendment indicates, the “new . . . sentence . . . is intended to overrule various cases to the effect that proceeds of insurance on collateral are not proceeds of the collateral.” Although this amendment has not yet been adopted in New York, it is a persuasive indication of the effect which § 9-306 was originally intended to have. . . . [T]he fact that the state legislature had not yet enacted this amendment does not preclude a federal court from rendering a decision which is consistent with the original intention underlying § 9-306.

PPG Indus. v. Hartford Fire Ins. Co., 531 F.2d 58, 61 (2d Cir. 1976) (quoting Reasons for Change, *supra* note 59, at 97-98) (first two omissions in original).

61. See U.C.C. § 9-306(1) (1990).

62. This characterization finds both support and criticism in § 9-504(1), which permits a secured party to “sell, lease, or otherwise dispose of” collateral after default. *Id.* § 9-504(1). On the one hand, one can argue that § 9-504(1) subsumes the terms “sell” and “lease” within the concept of disposition by using the word “otherwise,” so that leasing property constitutes a disposition under § 9-306(1). On the other hand, one can argue that the presence of the term “lease” in § 9-504(1) demonstrates that the drafters omitted it intentionally in § 9-306(1). The court in *In re Cleary Brothers Construction Co.*, 9 B.R. 40

leased property for a term, during which the lessor contractually agrees not to disturb the lessee's possession and use. Such a transfer of rights respecting property fits squarely within a meaningful conception of the term "disposition."⁶³

Most courts analyzing lease transactions under Section 9-306(1), however, have adopted a "permanent passage of title" analysis to conclude that rent payments are not proceeds of the leased collateral.⁶⁴ The seminal case addressing this issue is *In re Cleary Brothers Construction Co.*⁶⁵ In this case, Cleary Brothers owned a crane in which it had granted a security interest to General Electric Credit Corp. (GECC).⁶⁶ After filing for bankruptcy protection, Cleary Brothers leased the crane, without the permission or knowledge of GECC, to a third party for ten days at an agreed rent of \$10,668.⁶⁷ Upon learning of the lease, GECC argued to the bankruptcy court that the \$10,668 constituted proceeds of the crane that Cleary Brothers had to apply to satisfy GECC's claim.⁶⁸ The bankruptcy court disagreed, holding that "the term 'proceeds' does not include rents" paid for the use of the crane, since "[t]he words 'otherwise disposed of' related to a permanent or final conversion, not to a temporary use."⁶⁹ The bankruptcy court accordingly held that GECC had no lien on the \$10,668 of rent paid to Cleary Brothers.⁷⁰ According to the

(Bankr. S.D. Fla. 1980), seems to have embraced this latter argument. See *infra* notes 65-73 and accompanying text.

Taken in isolation, neither of these statutory arguments is compelling. As discussed in the following text, § 9-306(1) should be interpreted in the context of the U.C.C.'s evolving sensitivity to economic substance over legal form, as demonstrated in the 1972 amendment to § 9-306(1) and the 1987 amendment to § 1-201(37). See *infra* notes 74-81 and accompanying text; see also U.C.C. §§ 1-201(37), 9-306(1) (1990). Under this approach, the leasing of property would constitute a disposition within the meaning of § 9-306(1).

63. Cf. *Weisbart & Co. v. First Nat'l Bank*, 568 F.2d 391, 395 (5th Cir. 1978) ("[T]hough 'other disposition' cannot technically be characterized as a sale or exchange, at the minimum it must meet the threshold test of these two transactions by effecting a transfer of property.").

64. See *infra* note 72 and accompanying text.

65. 9 B.R. 40.

66. *Id.* at 40.

67. *Id.*

68. *Id.* at 41.

69. *Id.*; see also *Mechanics Nat'l Bank v. Gaucher*, 386 N.E.2d 1052, 1055 (Mass. App. Ct. 1979) (finding that "other disposition" as used in U.C.C. § 9-306(1) implies a "permanent transfer of possession"). The court in *Cleary Brothers* was interpreting the 1962 version of § 9-306(1), which read slightly differently in pertinent part from the 1972 version. See *supra* note 41.

70. *Cleary Bros.*, 9 B.R. at 41.

bankruptcy court, if GECC wanted a lien upon rents, it should have taken an assignment of any leases of the crane:

Had the [drafters of the U.C.C.] intended to extend the lenders lien to include rent from the temporary use of collateral which has been given as security, they would have included the term "leased."

This failure to do so could not have been inadvertent. The way to create a security interest in rent under the U.C.C. is to assign the lease or to give a security interest in the lease. The rent would then be the proceeds of the collateral⁷¹

Many subsequent judicial decisions revisiting this issue have agreed with *Cleary Brothers* without engaging in substantial analysis.⁷²

71. *Id.* By suggesting that GECC should have taken an assignment of the lease, the *Cleary Brothers* court merely begged the real question. If GECC had taken a direct assignment of the lease, GECC would have acquired without question a security interest in the rent due under that lease. That statement says nothing about whether or not the lease was not already GECC's collateral, as proceeds of the crane.

As discussed in the text, *Cleary Brothers'* rights as embodied in the lease of the crane (including the right to collect rents) are without question proceeds of the crane under § 9-306(1). *See* U.C.C. § 9-306(1) (1990). The U.C.C. acknowledges this point in § 9-308(b), which establishes the rule governing the priority disputes between an inventory lender and a purchaser of chattel paper, which can include a lease of goods under § 9-105(1)(b). *See id.* § 9-308(b) (providing that the purchaser of chattel paper for value in the ordinary course of business takes priority over an inventory lender claiming security interest in chattel paper "merely as proceeds of inventory subject to a security interest"). For an inventory lender to have a security interest in the lease of an item of inventory collateral "merely as proceeds" of that inventory, the lease of that item *must* constitute a disposition under § 9-306(1); otherwise, the inventory lender would have no basis for claiming any security interest in the chattel paper. *See id.* § 9-306(1).

As a result, the \$10,668 paid by *Cleary Brothers'* lessee on account of its contractual obligation was proceeds of the lease, which in turn was proceeds of the crane, squarely within § 9-306(1). GECC did not need to take an assignment of the lease in order to obtain a security interest in the rents; § 9-306(1) duplicates the expected *ex ante* bargain of the parties by automatically granting GECC a security interest in the lease. *See id.*

It is true that a prudent secured party in GECC's position should take a separate assignment of leases and should take possession of any lease entered into by the debtor. This would protect the secured party against the risk that the debtor might sell the lease to a subsequent purchaser for value, who would take priority as to the lease under § 9-308. *See id.* § 9-308. Thus, a prudent secured creditor must take these extra steps to obtain protection against third parties dealing subsequently with the debtor. However, these additional steps are unnecessary against the debtor and the bankruptcy trustee. Section 9-306's proceeds coverage alone suffices to protect the secured party against the debtor and lien creditors. *Cf.* 11 U.S.C. § 544(a) (1988) (providing that a bankruptcy trustee assumes the status of lien creditor against property of bankruptcy estate).

72. *E.g., In re Corpus Christi Hotel Partners*, 133 B.R. 850, 856 (Bankr. S.D. Tex. 1991); *In re Keneco Fin. Group*, 131 B.R. 90, 94 (Bankr. N.D. Ill. 1991); *In re Investment Hotel Properties*, 109 B.R. 990, 995-96 (Bankr. D. Colo. 1990); *In re A.E.I. Corp.*, 11 B.R. 97, 100-02 (Bankr. E.D. Pa. 1981). *But see In re Southern Equip. Sales Co.*, 24 B.R. 788,

Cleary Brothers' formalistic definition of the words "other disposition" is hopelessly inconsistent with the economic realities of property leasing. Debtor-owners of encumbered property can dispose of that property's economic value in several ways. They may dispose of the property's entire economic value at once in an outright sale. Alternatively, they may dispose of the property's economic value in a piecemeal fashion, by contracting away the collateral for temporary use over its useful life. For example, suppose Secured Party holds a security interest in Debtor's new truck. Unbeknownst to Secured Party, Debtor leases the truck to Lessee for \$300 per month, the same amount that Debtor must pay Secured Party under its security agreement. After three months of nonpayment by Debtor, Secured Party attempts to repossess the truck and discovers that Debtor has leased it to Lessee. By the time Secured Party repossesses the truck from Lessee, the truck has generated three months of use by Lessee and three contractual payments from Lessee to Debtor. The three months of use have consumed a portion of the truck's economic value, just as certainly as if Debtor had sold outright title to collateral worth an equivalent amount. The \$900 of lease payments simply reflects the exchange value that Debtor received for that portion of the truck's economic value.

Once one recognizes that leasing property consumes its economic value and productive capacity, *Cleary Brothers'* conclusion that Section 9-306(1) requires "a permanent or final conversion, not a temporary use"⁷³ becomes entirely unpersuasive. Such a permanent passage of title conception is flatly inconsistent with the rationale behind the 1972 revision to Section 9-306(1), which rejected the passage of title analysis manifested in early casualty insurance cases.⁷⁴ Further, the permanent passage of title concept was plainly contrary to Article 9's general philosophy that the location of title to collateral is

794 (Bankr. D.N.J. 1982) (characterizing sums paid upon leases of inventory collateral as proceeds received upon disposition of such collateral).

73. *Cleary Bros.*, 9 B.R. at 41; see also *In re S & J Holding Corp.*, 42 B.R. 249, 250 (Bankr. S.D. Fla. 1984) (finding that cash generated through collateral "not received from the sale of collateral, but rather, through the use of it . . . does not make it 'proceeds'"); *Mechanics Nat'l Bank*, 386 N.E.2d at 1055 (finding that "other disposition" as used in U.C.C. § 9-306(1) implies a "permanent transfer of possession").

74. See *supra* part II.B.1.

less significant in determining rights than the economic substance of the transaction.⁷⁵

Finally, the drafters dispelled any continuing doubt about the illegitimacy of the permanent passage of title concept in 1987 when they revised Section 1-201(37) and its definition of the term "security interest." Section 1-201(37) provides courts with guidance in classifying personal property leases as either true leases, which are outside the scope of Article 9's coverage, or disguised secured sales, subject to the provisions of Article 9.⁷⁶ Prior to 1987, Section 1-201(37)⁷⁷ provided little concrete guidance to courts and generated a morass of conflicting decisions. In 1987, the drafters responded with a more detailed definition⁷⁸ that emphasizes the economic substance of the leasing transaction:

Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and

- (a) the original term of the lease is equal to or greater than the remaining economic life of the goods,
- (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
- (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or
- (d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.⁷⁹

At first glance, this provision seems to have nothing to do with Section 9-306(1) and the scope of the term "proceeds." The amendment,

75. See U.C.C. § 9-202 cmt. (1990) ("The rights and duties of the parties to a security transaction and of third parties are stated in this Article without reference to the location of 'title' to the collateral.").

76. See *id.* § 1-201(37) cmt. 37 ("The focus of the changes [to the definition of security interest] was to draw a sharper line between leases and security interests disguised as leases to create greater certainty in commercial transactions.").

77. See *id.* § 1-201(37) (1972) (current version at U.C.C. § 1-201(37) (1990)).

78. *Id.* § 1-201(37) cmt. 37 (1990).

79. *Id.* § 1-201(37).

however, holds the key to the proper scope of the term "proceeds," for it further demonstrates the drafters' emerging focus upon economic reality as a determinant of the rights of parties to secured transactions rather than legal form.⁸⁰ As discussed above, when an owner leases property, this transfers a portion of the property's economic value and productive capacity to the lessee. If a lease transaction effectively transfers the *entire economic value* of the property to the lessee, then Section 1-201(37) treats the transaction as a sale rather than a lease. As a result, the lessor must comply with Article 9's filing requirements in order to protect its interest in the leased property against third parties.

Section 1-201(37) explicitly recognizes that the leasing transaction involves a transfer of economic value. Section 1-201(37) thus effectively requires courts to characterize a lease as a disposition under Section 9-306(1), as a simple example demonstrates. Assume Secured Party sells two new cars to Debtor. Secured Party retains a purchase money security interest in the cars, but does not take an assignment of leases. Each new car is worth \$10,000 and has an expected value of \$2,000 after 36 months of use. Debtor then leases the first car to Lessee #1 for \$320 per month for 36 months, with no option to purchase, and the second car to Lessee #2 for \$320 per month for 36 months with an option to purchase the car for \$250 at the end of the lease term. Under Section 1-201(37), Lease #1 is a true lease, since it affords the lessee no ability to capture the car's expected remaining economic value at the end of the lease term. Section 1-201(37) treats Lease #2, however, as a secured transaction, since Lessee #2 can acquire the car's remaining economic value for a nominal consideration upon compliance with the lease.⁸¹

In each case, Debtor disposes of its right to use the cars for a three-year period, during which one expects the respective lessees to consume \$8,000 of each car's economic value. Under the *Cleary Brothers* permanent passage of title analysis, Secured Party would have no security interest in the \$320 per month Debtor receives under Lease #1 because that is a true lease and Secured Party took no

80. The drafters advised that this definition was intended to "focus on economics." *Id.* § 1-201(37) cmt. 37.

81. See *id.* § 1-201(37)(d). Since it is reasonably certain that Lessee #2 will capture the full economic value of the collateral, § 1-201(37) treats Lease #2 as a sale *ab initio*. See *supra* notes 79-80 and accompanying text.

assignment of Lease #1. But since Lease #2 is a secured transaction, Lease #2 is treated as a sale. Since the word "sale" clearly appears in Section 9-306(1), the plain meaning of that Section would require the conclusion that each \$320 payment that Debtor receives from Lessee #2 is proceeds of the collateral.

If *Cleary Brothers* was correct, then Secured Party would have a lien upon the \$320 per month paid by Lessee #2, but not upon the \$320 per month paid by Lessee #1. Such a result is absurd, since both leases have exactly the same effect upon Secured Party's collateral. During their respective terms, each lease takes a portion of the economic value of the property and transfers that value to the lessee. The lease payments represent compensation received by Debtor upon the exhaustion of that economic value. As between Debtor and Secured Party, the characterization of each lease as a "true lease" or "disguised sale" does not change the substance of the lessee's payments. Those payments fit within the scope of the term "proceeds" just as certainly as if outright title to collateral worth that amount had passed to the respective lessees.

To correctly classify lease payments as proceeds, therefore, one must appreciate that treating lease payments as proceeds in fact captures the *ex ante* bargain of the reasonable debtor and secured party. When the debtor "consumes" the economic value of collateral by permanent transfer of full title to a third party for cash, Sections 9-203(3)⁸² and 9-306⁸³ provide the secured party with a continuing lien upon that cash. These sections reflect the U.C.C.'s assumption that the reasonable debtor and secured party, bargaining *ex ante*, would understand that the secured party should retain an interest in that cash.⁸⁴ As demonstrated above, piecemeal consumption of the collateral by third parties has precisely the same effect on the secured

82. See U.C.C. § 9-203(3) (1990) ("Unless otherwise agreed a security agreement gives the secured party the rights to proceeds provided by Section 9-306.").

83. See *id.* § 9-306.

84. Professor Hawkland has suggested that § 9-203(3)

automatically gives the parties a right to collateral (proceeds) that is usually bargained for even in those cases in which the parties have forgotten to implement their bargain by appropriate language in the security agreement. In the unusual case in which the parties do not want proceeds included as part of the collateral, they have the option of excluding it Efficiency is promoted . . . because the parties must act affirmatively only in unusual cases

Hawkland, *supra* note 4, at 16.

party's collateral as an outright sale. Thus, one would expect the reasonable debtor and secured party to treat these situations in similar fashion, with the secured party obtaining an interest in the lease payments by virtue of Section 9-306's proceeds coverage.⁸⁵

Following the 1987 amendment to Section 1-201(37), the U.C.C.'s primary interpretive body explicitly tied together Sections 1-201(37) and 9-306(1) in a fashion that clearly rejects the passage of title conception of proceeds in favor of an economic, value-based conception of that term. In 1992, the Permanent Editorial Board of the U.C.C. rejected the *Cleary Brothers* case and its progeny in *PEB Commentary Number 9*, stating that

[w]here a debtor has granted to a secured party a security interest in goods that the debtor later leases as lessor, the lease rentals would constitute proceeds of the secured party's collateral for the reason that the debtor's conveyance of a leasehold interest in the goods constitutes a disposition of the goods for purposes of § 9-306(1).⁸⁶

Together with the 1987 amendment, *PEB Commentary Number 9* provides additional support for a broad, value-based conception of the term "proceeds," one that focuses on the presence of an event that exhausts the collateral's economic value or productive capacity of the bargained-for collateral.

85. Again, one can find additional support for this normative proposition in the Bankruptcy Code. First, under § 363(e), a bankruptcy court must prohibit a debtor from the use, sale, or lease of collateral over the secured party's objection unless the debtor can provide adequate protection of the secured party's interest. See 11 U.S.C. § 363(e) (1988). To the extent that the debtor's lease of the collateral threatens the value of the collateral, § 363(e) requires the debtor to provide the secured party with protection against this threat in the form of cash payments, a replacement lien, or otherwise. See *id.* § 361(1)-(3); EPSTEIN ET AL., *supra* note 57, § 10-5, at 739. Second, under § 552(b), the secured party's interest in prepetition collateral generally extends to rents, profits and products of that collateral even though the debtor may generate those rents, profits, and products postpetition. See Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 214, 108 Stat. 4106, 4126 (1994) (to be codified at 11 U.S.C. § 552(b)); *infra* notes 218-219 and accompanying text. Section 552(b) thus prevents the debtor from exhausting the value or productive capacity of the collateral to the detriment of the secured party's interest. Together, §§ 363(e) and 552(b) of the Bankruptcy Code capture the expected *ex ante* bargain of the reasonable debtor and secured party that if the debtor leases the collateral, the lease payments would also stand as security for the debt.

86. PEB COMMENTARY ON THE UNIFORM COMMERCIAL CODE, COMMENTARY No. 9 (1992) [hereinafter PEB COMMENTARY No. 9].

C. *Recognizing and Applying the Emerging True Scope of the Term "Proceeds"*

A proper understanding of the 1972 and 1987 amendments discussed above⁸⁷ is critical to the correct interpretation of Section 9-306(1)'s definition of the term "proceeds." These amendments rearticulated and reinforced the U.C.C. drafters' original intention that Article 9 should "make distinctions, where distinctions are necessary, along functional rather than formal lines."⁸⁸ Both individually and collectively, the 1972 and 1987 amendments reflect the concern of their respective drafters that as a matter of sound commercial policy, results should be informed by the economic substance of a transaction rather than its form.

From these amendments and their emphasis upon economic substance, one can easily extrapolate the proper scope of the term "proceeds" under Section 9-306. Whether the debtor retains title to the collateral is irrelevant; in an economic sense, the term "proceeds" properly includes whatever assets the debtor receives by virtue of an event that exhausts or consumes some or all of the collateral's economic value or productive capacity. Once courts appreciate the emphasis upon economic substance manifested so overtly in these amendments, courts cannot simply dismiss this underlying policy in favor of a formalistic passage of title analysis. The U.C.C.'s rules of construction expressly reject such formalistic interpretation, mandating instead a functional construction whereby U.C.C. provisions "shall be liberally construed and applied to promote its underlying purposes and policies."⁸⁹

Nevertheless, many courts refuse to acknowledge the emerging true scope of the term "proceeds" and continue to treat passage of title as the key to classification under Section 9-306(1).⁹⁰ One solution, of

87. See *supra* text accompanying notes 74-81.

88. U.C.C. § 9-101 cmt. (1990).

89. *Id.* § 1-102(1) (emphasis added). Comment 1 to § 1-102 provides further emphasis:

The Act should be construed in accordance with its underlying purposes and policies. The text of each section should be read in the light of the purpose and policy of the rule or principle in question, as also of the Act as a whole, and the application of the language should be construed narrowly or broadly, as the case may be, in conformity with the purposes and policies involved.

Id. § 1-102 cmt. 1.

90. See *supra* part II.A-B.

course, is to revise Article 9 to reverse these decisions and explicitly reject the passage of title concept as a legitimate basis for classifying assets as proceeds of collateral.⁹¹ The current Article 9 revision process should accomplish this solution eventually. In the meantime, however, cases continue to arise, such as those involving the proper characterization of stock dividends⁹² and tort claims⁹³ under Section 9-306. In deciding these cases, courts can and should read Section 9-306(1) broadly enough to give effect to the proper scope of the term "proceeds."

1. Stock Dividends as Proceeds: Rejecting the Tenth Circuit's *Hastie* Analysis

As discussed previously,⁹⁴ the Tenth Circuit concluded in *Hastie* that cash dividends did not constitute proceeds of stock within the meaning of Section 9-306(1).⁹⁵ This conclusion cannot be squared with the emerging economic scope of the term "proceeds," for cash dividends clearly reflect a return upon the productive capacity of stock.

a. The Case of the Liquidating Dividend

One can more easily understand the error in the Tenth Circuit's analysis in *Hastie* by considering how that court apparently would have interpreted Section 9-306(1) to classify a liquidating dividend. Suppose Debtor owns 248 shares of stock in ABC Company (ABC) and has granted Secured Party a security interest in those shares. The shareholders of ABC subsequently elect to dissolve the corporation, and upon that dissolution ABC pays to its shareholders a liquidating dividend of five dollars per share.

Such a liquidating dividend fits squarely within the scope of the term "proceeds," even if one adheres nominally to the passage of title conception. If each shareholder turns over possession of its share certificates in exchange for the dividend, the transaction would qualify as an exchange under Section 9-306(1).⁹⁶ If each shareholder instead

91. See *infra* part IV.

92. See *infra* part II.C.1.

93. See *infra* part II.C.2.

94. See *supra* notes 20-37 and accompanying text.

95. *In re Hastie*, 2 F.3d 1042, 1045 (10th Cir. 1993).

96. See U.C.C. § 9-306(1) (1990).

retained possession of its share certificates, the liquidating dividend still constitutes proceeds of the stock, as the liquidating dividend is the functional equivalent of a casualty that totally destroys the stock. After payment of the dividend, the remaining certificates are mere paper with no economic value since the underlying firm value was "disposed of" through a casualty—the dissolution and subsequent liquidation of the company. Therefore, as the United States Bankruptcy Court for the Southern District of Texas concluded in *Aycock v. Texas Commerce Bank, N.A.*,⁹⁷ and as the Tenth Circuit hinted in *Hastie*,⁹⁸ a liquidating dividend falls squarely within the scope of the term "proceeds" in Section 9-306(1).⁹⁹

b. Ordinary Cash Dividends

Must the foregoing analysis change if ABC declares and pays a cash dividend in the ordinary course of business operations? According to the Tenth Circuit in *Hastie*, the answer is "yes" because that dividend payment would not constitute a disposition of Secured Party's collateral.¹⁰⁰ As the Tenth Circuit reasoned:

The receipt of cash dividends by a registered owner of certificated securities bears no resemblance to the events specified in the definition of proceeds or to an act of disposition generally. Common stock represents an ownership interest in the issuing corporation. Under Oklahoma law, a cash dividend is a distribution of the issuing corporation's capital surplus or retained earnings. Thus, although the cash dividend distributes assets of the corporation, it does not alter the ownership interest represented by the stock. The cash dividend, therefore, is not a disposition of the stock. Normally, stock is not disposed of, sold, or exchanged in any way unless a change in the ownership interest in the issuing corporation is thereby effected.¹⁰¹

97. 127 B.R. 17 (Bankr. S.D. Tex. 1991).

98. 2 F.3d 1042. The Tenth Circuit did not expressly decide whether a liquidating dividend constituted proceeds of stock because that issue was "not presented." *Id.* at 1046. Nevertheless, the Tenth Circuit cited *Aycock*, which treated liquidating dividends as proceeds of stock, *id.* (citing *Aycock*, 127 B.R. at 18-19), and the *Hastie* court further noted that in dissolution situations, "an exchange of stock is frequently required." *Id.* Since the Tenth Circuit made this comment in an attempt to distinguish ordinary dividends from liquidating dividends, it seems fair to suggest that had the Tenth Circuit faced the question directly, it would have held that liquidating dividends constitute proceeds of stock.

99. *Id.*; *Aycock*, 127 B.R. at 18-19.

100. *Hastie*, 2 F.3d at 1045.

101. *Id.* at 1045-46 (citations omitted).

Boiled down to its essence, the Tenth Circuit's rationale is that since the FDIC still owns the stock, the cash dividends cannot be proceeds of the stock.¹⁰²

Since the Tenth Circuit relies entirely upon the passage of title conception rejected in the 1972 and 1987 amendments, however, its rationale lacks persuasive force. Likewise, the court's interpretation of Section 9-306(1) is further weakened by the court's attempt to contrast ordinary and liquidating dividends:

We need not decide if a different rule would be appropriate for a liquidating dividend as the issue is not presented. We note only that in such situations an exchange of stock is frequently required. Nor do we view ordinary cash dividends as something akin to a "recovery" for damage to the underlying stock. The impact of cash dividends on the value of common stock and on the equity of the stockholder therein is a factual matter of the kind and complexity outside the scope of this litigation. We are aware that under certain conditions so-called "ordinary cash dividends" under Oklahoma law might be paid out to a

102. *Id.* The Tenth Circuit also claimed to find additional support for its interpretation of proceeds in U.C.C. § 8-321(3). *Id.* at 1046-47. Section 8-321(3) provides:

A security interest in a security is subject to the provisions of Article 9, but:

- (a) no filing is required to perfect the security interest; and
- (b) no written security agreement signed by the debtor is necessary to make the security interest enforceable The secured party has the rights and duties provided under Section 9-207, to the extent they are applicable. . . .

U.C.C. § 8-321(3) (1990). Comment 3 to § 8-321 further states that "in the absence of agreement to the contrary, the secured party . . . would have the duty to remit dividends he received to the debtor or to apply them in reduction of the obligation under Section 9-207(2)(c)." *Id.* § 8-321 cmt. 3. From these sections, the Tenth Circuit reasoned that

it would be inconsistent with U.C.C. § 8-321 and U.C.C. § 9-207(2)(c) to treat cash dividends as proceeds of common stock. . . . It would be inconsistent to treat cash dividends as proceeds of the stock in which the security interest in the stock continued, and yet at the same time classify the cash dividends as increase and profits, and require that they be remitted to the debtor or applied to the secured obligation.

Hastie, 2 F.3d at 1046-47 (citations omitted).

This argument makes no sense. It is perfectly consistent to treat the FirstBank dividends as proceeds of the FirstBank stock and at the same time compel the FDIC to either remit the dividend to the debtor or to apply it against the debt. Secured parties cannot simply keep proceeds of collateral free and clear of the debtor's interest; the proceeds are only security for a debt. After default, Article 9 should require the secured party to either apply those moneys to the debt or remit them to the debtor, and this requirement should continue until the secured party forecloses the debtor's interest in the collateral. Thus, the fact that § 9-207(2) requires the secured party to account for any dividends has no relation to whether the dividends are proceeds of the stock.

point at or near the point of insolvency for the issuing corporation. We take some, albeit small, comfort in the fact that this is not the ordinary situation.¹⁰³

The Tenth Circuit's reasoning is unpersuasive for several reasons. First, under Oklahoma corporation law, Hastie's shares represented his proportionate residual claim against the net assets of FirstBank.¹⁰⁴ If under Oklahoma law Hastie's share certificates entitled him to a residual claim against FirstBank's net assets, simple math demonstrates that the payment of a cash dividend has the effect of reducing Hastie's residual claim.¹⁰⁵ Thus, despite the contrary

103. *Hastie*, 2 F.3d at 1046 (citations omitted).

104. OKLA. STAT. ANN. tit. 18, § 1035 (West 1986).

105. Assume that during the pendency of Hastie's bankruptcy, FirstBank declared and paid dividends totaling \$80 million. Following those dividends, FirstBank would retain \$80 million fewer in assets against which Hastie possesses a residual claim. By declaring and paying these dividends, FirstBank thus disposes of \$80 million of its firm value—value that is embodied in the share certificates that Hastie assigned to the FDIC as collateral.

It is true, of course, that no shareholder can take unilateral action to compel FirstBank to distribute his or her share of the residual value of FirstBank's assets. If a shareholder wishes to extract the value from his or her shares prior to FirstBank's dissolution, the shareholder's only option would be to sell his or her shares in a market transaction. As such, one might argue that the value of stock is not damaged by declaration and payment of a dividend unless one can demonstrate a resulting reduction in the share price. The debtor in *Hastie* made this very argument to support his claim that the dividends were not "proceeds" of the FirstBank stock:

[P]ayment of dividends by a solvent corporation is a distribution of profit which does not affect the underlying equity of the corporation. Stock prices do not rise and fall on a dollar for dollar basis with the payment of dividends. In fact, it is Debtor's belief that a history of dividend payments may increase the value of stock while the failure to pay a dividend in a given year could decrease the value of stock.

Brief of Appellee at 9, *In re Hastie*, 2 F.3d 1042 (10th Cir. 1993) (No. 92-6034).

This argument, however, confuses a company's dividend policy and its effect on share price with the effect of any specific dividend upon the firm value as reflected on its balance sheet. Finance theorists generally accept as correct the thesis of Modigliani and Miller that a company's dividend policy, or a change in that dividend policy, does not affect the value of the company's shares. See RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 376-80 (4th ed. 1991). Assuming the existence of perfectly efficient capital markets, a change in FirstBank's dividend policy should have no impact upon the share price of FirstBank stock because the stock price reflects the investors' interpretation of all available information, and not simply the investors' acceptance of management's hopes or fears about future earnings as reflected in the declared dividend. *Id.* at 383.

Once this is understood, it becomes apparent that the argument of the debtor in *Hastie* is incorrect. Efficient market theory suggests that an ordinary cash dividend would not cause a decrease in the price of the company's shares. Instead, one would expect the market to take into account the expectation of future dividends by the company and to make any corresponding adjustment in the price of the company's shares before the company actually

assertion of the Tenth Circuit in *Hastie*, the dividends in some sense are akin to a “‘recovery’ for damage to the underlying collateral”¹⁰⁶ and should be treated as proceeds of the stock under Section 9-306(1).

More significantly, when one acquires stock, one really acquires the right to the future productive capacity of those shares. This future productive capacity includes both share appreciation (increases in the firm’s share price over time) and dividends (periodic distributions of firm value). If the proper scope of Section 9-306(1) is to protect a secured party against exhaustion of the collateral’s productive capacity, declaration and payment of a cash dividend constitutes an event that falls within the proper conception of the term “proceeds” under Section 9-306(1).¹⁰⁷ The fact that the debtor still retains title to the stock and the right to future dividends does not change economic reality. The dividend is proceeds of the stock within the proper scope of Section 9-306(1).

2. Tort Settlements as Proceeds

Just as a secured party might claim a lien upon casualty insurance payments received on account of damaged collateral, a secured party might claim a lien upon its debtor’s legal claim against a tortfeasor who damaged the collateral. The tort claim and casualty insurance moneys are conceptually similar, as each arise on account of an event that damages the collateral’s economic value. Given this conceptual similarity, one might characterize the tort claim as proceeds of the collateral by characterizing the tort as a disposition of the collateral under Section 9-306(1). Early commentators, however, questioned whether the language of Section 9-306(1)

declares and pays any particular dividend. Accordingly, the fact that the company’s share price remains the same immediately following a dividend is irrelevant. Once it is declared and paid, the dividend is a disposition within the meaning of § 9-306(1), even though an efficient market will already have taken that dividend into account in setting the company’s share price.

106. *Hastie*, 2 F.3d at 1046; see also *McGonigle v. Combs*, 968 F.2d 810, 828 (9th Cir. 1992) (“If the purpose of [§ 9-306] is to be served, . . . the security-holder must be protected against diminutions in the value of the security that arise not only from sale, but also from other events or transactions that damage the security.”), *cert. dismissed*, 113 S. Ct. 399 (1992).

107. See PEB REPORT, *supra* note 15, at 111 (stating that a dividend is “so necessarily and obviously associated with an interest in [the stock] that a security agreement and financing statement ought not to be required to mention [it] explicitly”).

included tort settlements,¹⁰⁸ and several courts subsequently used the passage of title concept to exclude tort settlements from the scope of proceeds under Section 9-306(1).¹⁰⁹

The New York decision of *Bank of New York v. Margiotta*¹¹⁰ is typical of these cases. Simone and Linda Catalino owned a 1973 automobile subject to a security interest in favor of Bank of New York.¹¹¹ The automobile was destroyed in an accident while being driven by Charles Margiotta.¹¹² Following this accident and a default by the Catalinos, the Bank of New York obtained a judgment against the Catalinos, which was returned unsatisfied.¹¹³ At that point, the Bank of New York attempted to sue Margiotta for negligence, arguing that the Catalinos' negligence claim against Margiotta was identifiable proceeds of the automobile.¹¹⁴

The district court granted Margiotta's motion for summary judgment, refusing to construe Section 9-306(1) so broadly as to make the accident a disposition:

While a security interest continues in any identifiable proceeds of the collateral covered by the security agreement and a third party may be liable in conversion for paying those proceeds without satisfying the secured party's interest, it is unclear whether identifiable proceeds may be stretched to include a cause of action. This Court sees no justification in so extending the statute.¹¹⁵

The result in *Margiotta* is technically correct. Section 9-104(k) clearly states that Article 9 does not apply "to a transfer in whole or

108. E.g., Henry J. Boroff, *Insurance Proceeds Under Section 9-306: Before and After*, 79 COM. L.J. 442, 443-45 (1974); Hawkland, *supra* note 4, at 12-13. Although Professor Hawkland suggested that any distinction between tort settlements and insurance moneys was "hard to justify philosophically," he concluded that tort settlements "presumably" would not constitute proceeds following the 1972 amendment to § 9-306(1). *Id.*

109. *In re Boyd*, 658 P.2d 470, 471-74 (Okla. 1983); *Hoffman v. Snack*, 2 U.C.C. Rep. Serv. (Callaghan) 862, 863 (Pa. Comm. Pleas 1964); *see also* New England Mortgage Servs. Co. v. Petit, 590 A.2d 1054, 1055-56 (Me. 1991) (Maine statute extended a judgment creditor's lien to proceeds of the debtor's property to the same extent that a secured party would have interest in proceeds under § 9-306; court held that a judgment creditor could not assert a lien upon any proceeds to be derived from the debtor's pending malpractice claim, because Article 9 excludes tort claims from its scope).

110. 416 N.Y.S.2d 493 (Sup. Ct. 1979).

111. *Id.* at 494.

112. *Id.*

113. *Id.*

114. *Id.* at 494.

115. *Id.* at 495 (citations omitted).

in part of any claim arising out of tort.”¹¹⁶ Thus, the Bank of New York should have lost the case since the Catalinos’ right to sue could not be the subject of a valid security interest.¹¹⁷ The *Margiotta* court’s reasoning, however, is flawed. Section 9-104(k) has nothing to do with whether the tort claim constitutes proceeds of the automobile; that is determined solely by Section 9-306(1). Section 9-104(k) merely preempts the result otherwise dictated by Section 9-306, so that an Article 9 security interest does not arise against the tort claim, even if that tort claim would constitute proceeds of the automobile under Section 9-306.

A tort claim for negligent damage to collateral arises on account of an event that damaged the collateral’s economic value. As a result, a tort claim falls squarely within the proper scope of the term “proceeds” despite Section 9-104(k). As a few courts have correctly reasoned, further amendment to Section 9-306(1) is unnecessary to treat tort settlements as proceeds of collateral.¹¹⁸ The decision of the United States Court of Appeals for the Ninth Circuit in *McGonigle v. Combs*¹¹⁹ demonstrates an appropriate recognition of the emerging, economic conception of the term “proceeds.” Brownell and Leslie Combs were equal co-owners of Spendthrift Farms, Inc. (Spendthrift), one of the world’s largest horse breeding operations.¹²⁰ In 1983, the Combs sold \$35 million worth of stock in Spendthrift to thirty-four investors in a private placement.¹²¹ Spendthrift followed this private placement with a public offering of shares.¹²² In 1985, after a precipitous fall in the price of Spendthrift shares, private investors filed an action against the Combs for alleged violations of federal securities laws.¹²³

116. U.C.C. § 9-104(k) (1990).

117. This result likely will change when the revision to Article 9 is complete. The Article 9 Study Committee has recommended that Article 9 be revised “to include security interests in claims (other than claims for personal injury) arising out of tort, to the extent that such claims are assignable under applicable non-UCC law.” PEB REPORT, *supra* note 15, at 58.

118. *E.g.*, *McGonigle v. Combs*, 968 F.2d 810, 828 (9th Cir. 1992), *cert. dismissed*, 113 S. Ct. 399 (1992); *In re Falkenberg*, 136 B.R. 481, 484-86 (Bankr. N.D. Ohio 1992); *In re Stone*, 52 B.R. 305, 307-08 (Bankr. W.D. Ky. 1985).

119. 968 F.2d 810.

120. *Id.* at 814.

121. *Id.*

122. *Id.*

123. *Id.* at 815.

One of the plaintiffs, Casares, had borrowed \$750,000 from Central Bank in 1983 to finance the purchase of 100,000 shares of Spendthrift stock.¹²⁴ To secure this loan, Casares had pledged the stock to Central Bank, who was in possession of the certificates.¹²⁵ In 1988, after Leslie Combs settled the claims of all plaintiffs, including Casares, for \$2.1 million,¹²⁶ Central Bank asserted a priority claim upon Casares' share of the settlement funds as proceeds of the Spendthrift stock.¹²⁷ Casares' lawyers, who claimed an attorneys' lien against the settlement fund, objected on the ground that there had been no disposition of the stock.¹²⁸ The district court ruled in favor of Central Bank,¹²⁹ and the Ninth Circuit affirmed the judgment in a decision that squarely rejects the passage of title conception of proceeds:

[Casares' lawyers argue] that there has been no "sale, exchange, collection or other disposition of collateral," and that the terms of the statute therefore have not been met. If the purpose of the statute is to be served, however, the security-holder must be protected against diminutions in the value of the security that arise not only from sale, but also from other events or transactions that damage the security. The classic situation is that of a tort recovery obtained by a debtor for damage to secured property; the secured creditor obtains a lien on such a payment to replace the diminished value of the security. There has been no sale, and no alteration in ownership, but in a broad sense there has been a "disposition" of which the tort recovery represents the "proceeds."¹³⁰

Since the settlement compensated Casares for the lost economic value of the Spendthrift stock, the Ninth Circuit correctly concluded that Central Bank retained a lien upon the settlement payments as proceeds of that stock.¹³¹

124. *Id.* at 827.

125. *Id.*

126. Under the terms of the settlement agreement, there was no rescission of the original stock purchase, so the plaintiffs retained their Spendthrift shares. *Id.* Since the plaintiffs retained their shares, the settlement payments would not constitute proceeds under the passage of title conception.

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.* at 828 (citations omitted).

131. *Id.*

III. THE TRUE SCOPE OF "PROCEEDS" AND THE "NONEXISTENT COLLATERAL" PROBLEM

A. *Introducing the Nonexistent Collateral Problem*

Another set of proceeds cases exists in which courts also have construed Section 9-306(1) narrowly and in a fashion inconsistent with the emerging, value-based conception of the term. These cases involve the "nonexistent collateral" problem, demonstrated by the following hypothetical:

ABC Company (ABC) manufactures and sells widgets to retailers only on open account. ABC finances its operations through a \$1 million line of credit obtained from FirstBank. To secure this line of credit, FirstBank takes and duly perfects a first priority security interest upon ABC's accounts receivable. Shortly thereafter, XYZ Company (XYZ), ABC's primary competitor in the widget business, offers ABC \$1 million to stop manufacturing and selling widgets. ABC accepts the payment and closes its plant.

ABC's action in closing its plant has an apparent negative effect upon FirstBank's bargained-for collateral, since ABC no longer generates any accounts. Therefore, FirstBank might attempt to claim an interest in the \$1 million that XYZ paid to ABC, arguing that the payment is proceeds of its bargained-for collateral (ABC's accounts). This argument is plausible in an economic sense because the \$1 million payment, in part, is a substitute for the net present value of future accounts that ABC would have generated had it continued operating. Since FirstBank would have possessed a security interest in those future accounts, FirstBank might argue that it should have a continuing lien upon the \$1 million payment ABC received to cease operations.

A narrow reading of Section 9-306(1), however, presents what appears to be a threshold problem. How can an asset (the \$1 million cash payment) be proceeds of collateral that never came into existence (the accounts that ABC would have generated if it had not closed)? This is the nonexistent collateral dilemma, which has surfaced in judicial decisions in several different contexts, including disputes over government agricultural subsidy payments and proceeds of business interruption insurance.

1. Governmental Agricultural Subsidies

During the past dozen years, perhaps the most widely litigated proceeds issue has been whether a security interest in crops extends to government agricultural subsidy payments received by the debtor. Most of the cases have involved payments received by debtors under the federal payment-in-kind (PIK) agricultural subsidy program.¹³² Under the PIK program, farmers can agree with the government not to plant certain designated crops on a certain percentage of their acreage.¹³³ Once the farmer agrees to divert those acres, the farmer must maintain that acreage under conservation measures approved by the U.S. Department of Agriculture (USDA).¹³⁴ In exchange for this diversion, the USDA agrees to pay the farmer, either in kind or in certificate form, a fixed amount of the foregone crop equal to the expected yield of the diverted land.¹³⁵

By participating in the PIK program, the farmer's agreement to divert acreage becomes a valuable asset that the farmer can sell or use as collateral.¹³⁶ The widespread use of PIK contracts in this fashion created numerous priority conflicts between farm lenders claiming a security interest in crops and either (a) the bankrupt farmer (or the bankruptcy trustee) or (b) a subsequent creditor claiming a direct security interest in the right to payment under the PIK contract. To obtain priority as to the PIK payments, the crop lender would have to demonstrate that the PIK payments are identifiable proceeds of the crops in which the crop lender possessed a duly perfected security interest.¹³⁷

132. For a basic overview of federal agricultural subsidy programs and some of the pitfalls associated with using subsidy payments as collateral, see Steven C. Turner & Dawnvolynn D. Callahan, *The Nature, Treatment, and Classification of Security Interests in Government Farm Payment Programs and Related Issues*, 10 J. AGRIC. TAX'N & L. 195, 203-15 (1988).

133. *Id.* at 199.

134. *In re Schmidt*, 38 U.C.C. Rep. Serv. (Callaghan) 589, 590 (Bankr. D.N.D. 1984).

135. *Id.*

136. 2 QUINN, *supra* note 14, ¶ 9-306[A][17], at 9-315.

137. The farm lender, of course, could have simply included PIK contract rights within the original collateral, thereby obviating the need to rely upon § 9-306(1)'s proceeds coverage. Many courts have concluded that the farm lender's failure to do so means that the farm lender took no security interest in PIK contract rights. *E.g., In re Schmalig*, 783 F.2d 680, 684 (7th Cir. 1986). This argument is subject to the identical criticism leveled earlier at the *Cleary Brothers* case—the failure of the farm lender to take a direct security interest in the PIK contract rights has nothing to do with whether those rights are properly characterized as proceeds of the farmer's crops. *See supra* note 71.

A substantial number of courts held that crop lenders could not overcome the nonexistent collateral problem, concluding that PIK payments could not be considered proceeds of crops when the farmer never planted that crop.¹³⁸ The leading case adopting this position is the decision of the United States Court of Appeals for the Seventh Circuit in *In re Schmaling*.¹³⁹ The debtors in *Schmaling* were Illinois farmers who granted a security interest in 1982 to First National Bank of Freeport (FNB) covering all "crops grown or growing . . . and which are now located on the [debtors'] real estate . . . together with all property of a similar nature or kind . . . which may be hereafter acquired."¹⁴⁰ In 1983, the debtors entered into a PIK contract entitling them to a total of 35,772 bushels of surplus corn.¹⁴¹ The debtors used the rights under this PIK contract as collateral to obtain additional operating loans and supplies from parties other than FNB.¹⁴²

In March 1984, the debtors filed for bankruptcy.¹⁴³ When FNB asserted a continuing security interest in the debtors' PIK corn, the debtors filed an adversary proceeding seeking a judgment that FNB possessed no such security interest.¹⁴⁴ In a decision affirmed by the district court, the bankruptcy court ruled in favor of FNB, stating that "although the agreement did not contemplate the not-as-yet-commenced Payment-in-Kind program and its proceeds specifically, its coverage was intended to be broad so as [to] cover all of the debtor's farm-related assets."¹⁴⁵ The Seventh Circuit reversed, however, rejecting FNB's argument that the PIK payments were proceeds of the crops described in FNB's security agreement.¹⁴⁶

138. See, e.g., *In re Kingsley*, 865 F.2d 975, 979 (8th Cir. 1989); *Schmaling*, 783 F.2d at 683; *In re Sunberg*, 729 F.2d 561, 562 (8th Cir. 1984); *In re Clark*, 82 B.R. 131, 133 (Bankr. D. Colo. 1987); *United States v. Carolina E. Chem. Co.*, 638 F. Supp. 521, 524-25 (D.S.C. 1986); *In re Mattick*, 45 B.R. 615, 617 (Bankr. D. Minn. 1985); *In re Binning*, 45 B.R. 9, 12 (Bankr. S.D. Ohio 1984); *In re Liebe*, 41 B.R. 965, 967-68 (Bankr. N.D. Iowa 1984); *In re Fowler*, 41 B.R. 962, 963-64 (Bankr. N.D. Iowa 1984); *In re Schmidt*, 38 B.R. 380, 383 (Bankr. D.N.D. 1984); *Fayette County Farms v. Vandalia Farms*, 521 N.E.2d 300, 302 (Ill. App. Ct. 1988).

139. 783 F.2d 680.

140. *Id.* at 681 (quoting the security agreement entered into by the debtors).

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.* at 681-82.

145. *Id.* at 682 (quoting the holding of the bankruptcy court).

146. *Id.* at 682-84.

As the language of its opinion demonstrates, the *Schmalings* court was troubled by the nonexistent collateral problem:

For something to be “proceeds” of crops . . . it must be received upon their “sale, exchange, collection or other disposition.” But in the instant case there was never a crop of which to dispose. No corn was grown on the Schmalings’ real estate. One condition for participating in the PIK program was that individuals *not* plant a crop.

As a consequence . . . inkind payments do not constitute proceeds of crops.¹⁴⁷

FNB attempted to address the nonexistent collateral problem by arguing that (a) the debtors would have grown corn but for their participation in the PIK program; (b) the corn, had the debtors grown it, would have been covered by FNB’s security interest; and (c) the PIK corn was just a substitute for the diverted crop and thus should be treated as proceeds within the spirit of Section 9-306(1).¹⁴⁸ The Seventh Circuit acknowledged that this argument possessed economic force, especially considering the structure of the PIK program.¹⁴⁹ Nevertheless, the Seventh Circuit refused to budge from taking a narrow view of the term “disposition,” holding that the PIK crops were not from the farmers’ own land and that “the broad economics of the transaction [should not] override the plain language of a security agreement which extends only to crops [and] . . . clear deficiencies in the description of the collateral.”¹⁵⁰

2. Business Interruption Insurance Payments

The nonexistent collateral problem also arises in cases involving business interruption insurance moneys. Suppose that ABC Company (ABC), which sells fuel oil, obtains financing from FirstBank. To secure this financing, ABC grants FirstBank a first priority floating lien upon ABC’s accounts and general intangibles.

147. *Id.* at 682-83 (citations omitted).

148. *Id.*

149. The *Schmalings* court stated:

This argument has a certain appeal from an economic perspective since the government based its PIK calculations on the farmer’s past and anticipated yields and intended the program to reduce production of certain crops. This appeal is perhaps even greater where the farmer is paid in the commodity he would have planted.

Id. at 683 (citation omitted).

150. *Id.*

A neighboring landowner then undertakes major construction adjacent to ABC's plant, during which a third party negligently damages ABC's pipelines. The damage effectively puts ABC out of business for several months and forces ABC into a Chapter 11 proceeding. As a result of the damage, ABC collects \$130,000 under the terms of an insurance policy that covers ABC against losses suffered due to business interruption. Are the \$130,000 unencumbered funds available for ABC's use in its reorganization? Or does FirstBank have a secured claim against the \$130,000 as proceeds of its collateral under Section 9-306(1)?

Clearly, FirstBank cannot argue that the claim against ABC's business interruption insurer is a general intangible directly covered by its security agreement. As Section 9-104(g) makes clear, and as numerous courts have recognized, any transfer by ABC of a claim against its insurer falls outside the scope of Article 9.¹⁵¹ FirstBank might claim, however, that the insurance moneys are a substitute for ABC's goodwill or for the accounts and contract rights that ABC would have generated but for the business interruption. Under this rationale, FirstBank might argue that the insurance moneys are derivative proceeds of FirstBank's collateral within the proper scope of Section 9-306(1).

Based upon the nonexistent collateral problem, however, one bankruptcy court recently rejected the argument that a creditor such as FirstBank could claim a lien upon the insurance moneys. In *In re Kroehler Cabinet Co.*,¹⁵² the United States Bankruptcy Court for the Western District of Missouri stated:

151. See U.C.C. § 9-104(g) (1990) (providing that "[t]his Article does not apply . . . to a transfer of an interest in or claim in or under any policy of insurance, except as provided with respect to proceeds (Section 9-306) and priorities in proceeds (Section 9-312)"); see, e.g., *In re Kroehler Cabinet Co.*, 129 B.R. 191, 194 (Bankr. W.D. Mo. 1991) (stating that the transfer of an interest or claim in any insurance policy is beyond the scope of Article 9), *rev'd sub nom.*, *MNC Commercial Corp. v. Rouse*, No. 91-0615-CV-W-2, 1992 WL 674733 (W.D. Mo. Dec. 15, 1992). As such, a creditor can only obtain a lien upon an insurance policy under non-Article 9 law, typically by having the creditor named as a loss payee under the policy.

Just as Article 9's exclusion of tort claims as collateral may change, see *supra* note 117 and accompanying text, so may Article 9's current exclusion of insurance policies as collateral. The *PEB Report* recommended that "[t]he Drafting Committee should give serious consideration to revising § 9-104(g) to expand the scope of Article 9 to include security interests in most forms of business insurance policies." *PEB REPORT*, *supra* note 15, at 56.

152. 129 B.R. 191.

[T]he proceeds from the Business Interruption Policy were not insurance proceeds resulting from the destruction of [the debtor's] equipment, work-in-process, inventory or personal property. Rather, they were paid as the result of actual loss of business income [that the debtor] sustained due to the necessary suspension of its operations. Thus, the proceeds paid from the Business Interruption Policy were not derivative proceeds under Section 9-306(1) because they were not paid as the result of damage to [the] collateral.¹⁵³

Also relying upon the nonexistent collateral problem, another bankruptcy court stated that “in the case of business interruption insurance, the policy does not insure any of the creditor’s collateral; it simply insures the debtor against interruption of its business.”¹⁵⁴

B. *Debunking the Nonexistent Collateral Problem*

To see courts embrace the nonexistent collateral theory in interpreting Section 9-306(1) is to watch history repeat itself. Decades ago, courts sacrificed potential advances in commercial finance by adhering formalistically to the axiom *qui non habet, ille non dat* (“what one does not have, one cannot give”). Of course, this axiom expresses a useful, common-sense limitation upon a person’s ability to convey property rights. Many courts took this notion far beyond its sensible application, however, invoking the axiom as a basis for concluding that one cannot convey or assign things expected to be owned in the future, but not yet owned or in existence.¹⁵⁵ This reasoning reached its zenith/nadir in the decision of the Supreme Judicial Court of Massachusetts in *Taylor v. Barton-Child Co.*¹⁵⁶ In *Taylor*, the court struck down a simple floating lien against a debtor’s accounts, holding that a creditor could not enforce a debtor’s assignment of future accounts against the trustee in

153. *Id.* at 195.

154. *In re Investment & Tax Servs.*, 148 B.R. 571, 574 (Bankr. D. Minn. 1992).

155. *E.g.*, *Skipper v. Stokes*, 42 Ala. 255, 258 (1868) (accounts); *Durant v. D’Auxy*, 33 S.E. 478, 481 (Ga. 1899) (tangible property); *Ainsworth v. Mobile Fruit & Trading Co.*, 29 S.E. 142, 142 (Ga. 1897) (accounts); *Taylor v. Barton-Child Co.*, 117 N.E. 43, 44 (Mass. 1917) (accounts); *First Nat’l Bank of Houston v. Campbell*, 193 S.W. 197, 198-99 (Tex. Ct. App. 1917) (accounts); *Huling, Brockerhoff & Co. v. Cabell*, 9 W. Va. 522, 527-28 (1876) (accounts); *O’Niel v. Helmke*, 102 N.W. 573, 574 (Wis. 1905) (accounts).

156. 117 N.E. 43.

bankruptcy.¹⁵⁷ The *Taylor* opinion included the following assertions, clearly outmoded by today's standards:

There can be no present conveyance or transfer of property not in existence, or of property not in the possession of the seller to which he has no title. . . .

There is an exception at the common law to the effect that one may sell that in which he has a potential title although not present actual possession That principle of the common law has never been carried so far as to include the case at bar. The catch of fish expected to be made upon a voyage about to begin cannot be sold. There can be no sale of the wool of sheep, the crop of a field, or the increase of herds not owned but to be bought, and there can be no assignment of wages to be earned under a contract of employment to be made in the future.¹⁵⁸

These assertions were outmoded even when the *Taylor* court made them in 1917. As Professors Gilmore and Kripke recognized, the business financing community chose to use future receivables of the manufacturer, the dealer, and the service provider as collateral because those receivables were similar to fixed, long-term assets well-suited for business financing.¹⁵⁹ Under pre-U.C.C. accounts receivable financing, the parties expected that the debtor would conduct future operations and generate future revenues, to which the secured party's lien would attach. The *Taylor* court's invocation of the *qui non habet* axiom merely served to defeat the *ex ante* bargain of debtors and creditors.

As a result, the rationale of decisions like *Taylor* lacked long-term staying power. In time, case law might have recognized, "by analogy to the common law doctrine of potential possession, the effectiveness of present assignments of the future receivables of a going enterprise."¹⁶⁰ Legislative reform short-circuited the common law process, however, and expressly sanctioned the use of after-acquired property as collateral. The current version of this legislative reform is Article 9, which rejects the nonexistent collateral problem by

157. *Id.* at 44.

158. *Id.* at 43-44 (citations omitted).

159. 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 7.11, at 236 (1965); Homer Kripke, *Current Assets Financing as a Source of Long-Term Capital*, 36 MINN. L. REV. 506, 510-13 (1952).

160. GILMORE, *supra* note 159, § 7.11, at 238.

stating that “any and all obligations covered by the security agreement [may] be secured by after-acquired collateral.”¹⁶¹

The use by modern courts of the nonexistent collateral concept to decide the PIK and business interruption cases is as formalistic as the *Taylor* decision. As discussed below, use of the nonexistent collateral problem to limit the scope of the term “proceeds” under Section 9-306(1) merely frustrates the *ex ante* bargain of the reasonable debtor and secured party.

1. PIK Payments as Proceeds of Crops

a. The Proper Interpretation of Section 9-306(1) as Applied to PIK Payments

In the PIK cases, the *ex ante* expectations of the parties are relatively clear. Assume Secured Party has just accepted an interest in Debtor’s as-yet unplanted corn crop as security for a loan. An objective observer, looking at the security agreement, would conclude that Debtor and Secured Party share a mutual understanding: Debtor will plant and grow corn to which Secured Party’s interest will attach.

If Debtor carries out this expectation, there is no question about the validity of Secured Party’s interest in Debtor’s corn harvest. But what if Debtor does not carry out this expectation and instead exchanges her rights to plant corn for a PIK contract that pays her *not* to plant corn? In that case, the Debtor effectively has liquidated the bargained-for collateral, just as if Debtor in fact had grown the corn, harvested it, and then sold it for cash. Just as security law would treat the cash proceeds of Debtor’s corn harvest as proceeds of the corn, security law should likewise treat the PIK contract as proceeds of the bargained-for collateral. Applying the nonexistent collateral rule to prevent this result frustrates the *ex ante* bargain of the parties and accords Debtor a windfall.

While most federal courts have failed to acknowledge this point,¹⁶² many state court decisions and a few well-reasoned federal court decisions have determined that sound commercial policy dictates

161. U.C.C. § 9-204(1) (1990).

162. See *supra* note 138 and accompanying text.

that PIK payments be classified as proceeds under Section 9-306(1).¹⁶³ The decision of the Supreme Court of Texas in *Sweetwater Production Credit Ass'n v. O'Briant*¹⁶⁴ is typical of these cases. In *O'Briant*, Sweetwater Production Credit Association (PCA) held a duly perfected security interest in the debtor's crops.¹⁶⁵ Subsequently, O'Briant, the debtor's father-in-law, loaned the debtor additional funds, taking a security interest in the debtor's PIK cotton.¹⁶⁶ After default by the debtor, both PCA and O'Briant claimed priority against the PIK cotton.¹⁶⁷ O'Briant claimed that the debtor's PIK entitlements were "general intangibles" against which PCA at best possessed an unperfected security interest, due to its failure to file a financing statement in the secretary of state's office.¹⁶⁸ PCA argued that the PIK cotton constituted proceeds of the debtor's crops, in which PCA possessed an unquestionably perfected prior lien.¹⁶⁹

In a unanimous opinion, the Texas Supreme Court recognized the split of authority and concluded that "the better reasoned view is the one that classifies PIK contracts within the definition of proceeds."¹⁷⁰ The court dismissed the nonexistent collateral problem, instead focusing upon the *ex ante* bargain of the parties as the key to classification under Section 9-306(1). As the court recognized, treating PIK contracts as proceeds of crops "effects the intent of the parties as the PIK contracts are merely substitutes for the crops that otherwise would have been planted."¹⁷¹ The *O'Briant* court further justified its construction of Section 9-306(1) as a means to prevent debtors from taking opportunistic action to defeat bargained-for

163. *In re Patsantaras Land & Livestock Co.*, 60 B.R. 24, 25 (Bankr. D. Colo. 1986); *Osteroos v. Norwest Bank Minot, N.A.*, 604 F. Supp. 848, 849 (D.N.D. 1984); *In re Judkins*, 41 B.R. 369, 372 (Bankr. M.D. Tenn. 1984); *In re Cupp*, 38 B.R. 953, 955 (Bankr. N.D. Ohio 1984); *In re Lee*, 35 B.R. 663, 667 (Bankr. N.D. Ohio 1983); *Production Credit Ass'n v. Martin County Nat'l Bank*, 384 N.W.2d 529, 531-32 (Minn. Ct. App. 1986); *Farmers & Merchants Nat'l Bank v. Sooner Coop.*, 766 P.2d 325, 327-28 (Okla. 1988); *Sweetwater Prod. Credit Ass'n v. O'Briant*, 764 S.W.2d 230, 232 (Tex. 1988).

164. 764 S.W.2d 230.

165. *Id.* at 230.

166. *Id.* at 231.

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.* at 232.

171. *Id.*

security interests by entering into PIK contracts instead of planting crops.¹⁷²

b. An Aside: Negotiable and Quasi-Negotiable Proceeds

Certainly, the *O'Briant* court's interpretation of Section 9-306(1) is more consistent with the expected *ex ante* bargain of the reasonable debtor and secured party than the interpretation set forth in *Schmaling* and its progeny. Likewise, the *O'Briant* court's construction of Section 9-306(1) is more faithful to the U.C.C.'s directive in Section 1-102(1) that the U.C.C. be "liberally construed and applied to promote its underlying purposes and policies."¹⁷³ This does not mean, however, that the end result in the *O'Briant* case—that PCA prevailed over the subsequent secured party—was the desirable or correct result. In a case like *O'Briant*, Article 9 should

172. *Id.* Other courts likewise have embraced the policy justification for the *O'Briant* case, noting that "[a] flexible interpretation of the concept 'proceeds' promotes responsible management of farming operations by allowing alternatives to growing crops while simultaneously protecting creditors' security interests." *In re Judkins*, 41 B.R. 369, 373 (Bankr. M.D. Tenn. 1984); *Farmers & Merchants Nat'l Bank v. Sooner Coop.*, 766 P.2d 325, 328 (Okla. 1988) (quoting *Judkins*, 41 B.R. at 373).

The Seventh Circuit in *Schmaling* failed to give due consideration to this "anti-opportunism" policy. Notably, the district court in the *Schmaling* case had agreed with *O'Briant's* rationale, concluding that "[i]f PIK payments were not proceeds, a farmer could abandon all farming activities in favor of program participation, thereby allowing him to dissipate the proceeds of the programs without any regard for his creditors' interests." *In re Schmaling*, 783 F.2d 680, 684 (7th Cir. 1986) (quoting the district court's unpublished opinion). The Seventh Circuit rejected this argument, however, stating that "[t]his argument can be made anytime a farmer finds a substitute use of his land, such as using his fields for a rock concert or a fairground instead of for the growing of crops. Clearly, income derived from such alternative uses could not be considered crop proceeds." *Id.*

The Seventh Circuit's argument proves too much, however. If the debtor uses his fields for a rock concert or a fairground, then the debtor is not acting as a farmer. Farmers do not stage rock concerts or fairs; farmers operate farms on which they grow crops. If the debtor rents his fields for a rock concert, one examining the security agreement, which describes crops, cannot reasonably conclude that rational persons in the positions of debtor and secured party would have understood that the rents would be covered by the security agreement (assuming that the agreement covers only crops, and not the land itself). Thus, the secured party should receive no continuing lien upon those rents.

Farmers who receive PIK payments, however, are still acting as farmers, albeit ones who have agreed contractually to leave a portion of their acreage out of production. In exchange for the agreement not to grow corn, the government agrees to provide the farmer with surplus corn. After examining the security agreement, one would conclude that a reasonable debtor and secured party would have understood that this surplus corn fits within the bundle of collateral granted to the secured party.

173. U.C.C. § 1-102(1) (1990); see *supra* note 89 and accompanying text.

provide a negotiability rule that enables the second secured party (the father-in-law) to prevail over the first secured party (PCA), notwithstanding Section 9-306(1)'s continuing proceeds coverage.

There are certain assets that, if left in the possession of the debtor, give third parties the appearance that the debtor can pass good title to those assets. Cash is the clearest example. Suppose that Debtor sells Secured Party's collateral for cash and then uses those cash proceeds to purchase a machine from X. Since those cash proceeds are negotiable, the common law does not allow Secured Party to reclaim the cash proceeds from X, even though the cash might be identifiable proceeds of the collateral under Section 9-306(2) and even though Secured Party may have a perfected security interest in those proceeds under Section 9-306(3).¹⁷⁴ The common law doctrine of negotiability of money, which the U.C.C. apparently embraces,¹⁷⁵ allows third parties such as

174. The common law conception of negotiability of money is commonly associated with the ancient case of *Miller v. Race*, 97 Eng. Rep. 398 (K.B. 1758), in which the court held that money cannot be recovered from "the hands of a person who bonâ fide took it in the course of currency, and in the way of his business." *Id.* at 402; accord *Holly v. Missionary Soc'y of Protestant Episcopal Church*, 180 U.S. 284, 294 (1901); *In re Brainard Hotel Co.*, 75 F.2d 481, 482 (2d Cir. 1935); *Arlington Park Racetrack v. SRM Computers*, 674 F. Supp. 986, 992 (E.D.N.Y. 1987); *Transamerica Ins. Co. v. Long*, 318 F. Supp. 156, 160 (W.D. Pa. 1970); *Porter v. Beha*, 8 F.2d 65, 74 (D.N.Y. 1925), *aff'd*, 12 F.2d 513 (2d Cir. 1926); *Merchants' Loan & Trust Co. v. Lamson*, 90 Ill. App. 18, 20 (App. Ct. 1900); *First Nat'l Bank v. Gibert & Clay*, 123 La. 845, 852-53, 49 So. 593, 596 (1909); *Babcock v. Standish*, 33 A. 385, 387-88 (N.J. Eq. 1895); *Newhall v. Longacre Bank*, 162 N.E. 23, 23 (N.Y. 1928); *Stephens v. Board of Educ.*, 79 N.Y. 183, 186-88 (1879); *Matteawan Mfg. Co. v. Chemical Bank & Trust Co.*, 279 N.Y.S. 495, 502 (App. Div. 1935), *modified*, 3 N.E.2d 845 (N.Y. 1936); *City of Portland v. Berry*, 739 P.2d 1041, 1043-44 (Or. Ct. App. 1987); *Steve H. Nickles & Edward S. Adams, Tracing Proceeds to Attorneys' Pockets (and the Dilemma of Paying for Bankruptcy)*, 78 MINN. L. REV. 1079, 1134-42 (1994) (discussing the common law rule of negotiability).

175. No courts seem to have suggested that Article 9 had the effect of displacing the common law rules concerning the negotiability of money. Further, the official comments seem to indicate that the drafters understood that the U.C.C. would not displace the common law negotiability of money. See UCC § 9-306 cmt. 2(c) (1990) ("Where cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds."). The *PEB Report* nevertheless recommended the revision of the official comments to make this understanding explicit:

The official comments to § 9-306 should be revised to reflect that Article 9 does not displace non-UCC rules of negotiability and finality of payment that otherwise would apply to cash proceeds and funds paid from a deposit account constituting proceeds. The revised comments should indicate that a good faith purchaser of cash proceeds or of funds transferred or paid from a deposit account constituting cash proceeds takes free of security interests to the same extent that the purchaser would take free of other competing claims.

X to rely safely upon Debtor's possession of cash as a sufficient indicator of Debtor's capacity to convey good title.

Likewise, the same result would occur if Debtor had sold the collateral in exchange for a negotiable instrument that Debtor had in turn negotiated to X. Even though the negotiable instrument would be identifiable proceeds of Secured Party's collateral under Section 9-306(2), X would prevail over the Secured Party in a priority contest.¹⁷⁶ Effectively, the U.C.C. makes a policy judgment, based upon common commercial practice, that the law should protect subsequent purchasers like X with a negotiability rule in order to facilitate commerce in such assets.¹⁷⁷ As a result, if Secured Party wants to prevent Debtor from effectively disposing of negotiable proceeds of its collateral, Secured Party must take possession of those proceeds.

Other assets carry an aura of "quasi-negotiability." If Debtor had sold the collateral in exchange for a nonnegotiable promissory note, that "instrument"¹⁷⁸ would constitute proceeds of Secured Party's collateral, and the Secured Party would obtain a continuing security interest in the note under Section 9-306(2).¹⁷⁹ If Debtor retains possession of the note, however, and transfers it to X to purchase a machine or some other asset, X likely will prevail in a priority contest with Secured Party.¹⁸⁰ Likewise, if Debtor had sold the collateral and received both a note and security agreement, collectively treated as

PEB REPORT, *supra* note 15, at 120.

176. See U.C.C. § 9-309 (1990) (providing that nothing in Article 9 limits the rights of a holder in due course of a negotiable instrument to enforce that instrument and that the rights of a holder in due course take priority over prior perfected security interests).

177. See, e.g., 2 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 24-12, at 349-50 (practitioner's 3d ed. 1988) (suggesting that free transfer of negotiable instruments would be impaired "if every transferee were obliged to check the filings every time he took such an instrument").

178. Article 9 defines "instrument" as any "writing which evidences a right to the payment of money . . . and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment," regardless of whether the writing itself is negotiable. U.C.C. § 9-105(1)(i) (1990).

179. See *id.* § 9-306(2).

180. See *id.* § 9-308(a) (providing that the purchaser of an instrument "who gives new value and takes possession of" an instrument in the ordinary course of business takes priority over a competing proceeds security interest under § 9-306 if the purchaser lacks knowledge of the competing security interest); see also *id.* § 9-308(b) (providing that the purchaser of an instrument that is proceeds of inventory and "who gives new value and takes possession of" an instrument in the ordinary course of business takes priority under § 9-306 over a competing proceeds security interest regardless of the purchaser's knowledge).

"chattel paper,"¹⁸¹ Secured Party would obtain a continuing security interest in the chattel paper under Section 9-306(2).¹⁸² Nevertheless, if Debtor retains possession of the chattel paper, and transfers it to X to purchase a machine or some other asset, X again will usually prevail in a priority dispute with Secured Party.¹⁸³ Here too, the U.C.C. makes a policy judgment that a debtor's possession of quasi-negotiable assets usually justifies a third party purchaser's reliance upon the appearance that the debtor can transfer good title to those assets.¹⁸⁴

The U.C.C.'s treatment of cash, instruments, and chattel paper stands in stark contrast to its treatment of "nonnegotiable" collateral such as accounts. Purchasers of accounts generally do not receive the benefit of the negotiability rules accorded to purchasers of cash, instruments, and chattel paper.¹⁸⁵ Thus, if Debtor had sold Secured Party's collateral in exchange for an account, and had transferred the account to X to purchase some other asset, X would not prevail over Secured Party in a priority dispute.

To the extent that PIK certificates are conceptually and practically similar to quasi-negotiable collateral, Article 9 should cloak them with an aura of negotiability. The federal statute governing annual agricultural commodity programs specifies that the USDA may make in-kind payments by the issuance of "negotiable certificates" redeemable for a commodity.¹⁸⁶ The statute's use of the term "negotiable" is instructive, suggesting that Congress envisioned that PIK certificates would need to be accepted essentially as cash

181. Article 9 defines "chattel paper" as "a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods." U.C.C. § 9-105(1)(b) (1990).

182. See *id.* § 9-306(2).

183. See *supra* note 180.

184. As White and Summers have suggested:

In effect, the drafters have judged that businessmen and lenders should be permitted to purchase chattel paper without having first to examine the files—at least in cases in which they put out new money, take possession and conduct the transaction in the ordinary course of their business. The [U.C.C.] thus accommodates the business expectation of quasi-negotiability—the expectation by businessmen that one who "buys" such paper in ignorance of others' claims and takes possession of it has a first claim to the paper.

2 WHITE & SUMMERS, *supra* note 177, § 26-18, at 550; see also 2 GILMORE, *supra* note 159, § 25.5, at 669 ("Chattel paper, it was felt, had become a sort of commercial specialty and had traveled a good part of the familiar road toward negotiability.").

185. See 2 WHITE & SUMMERS, *supra* note 177, § 26-18, at 548.

186. 7 U.S.C. § 1445k(b)(3) (Supp. V 1993).

equivalents to serve their intended function. The language of the statute reinforces this notion, permitting the USDA to make payments by any method that the USDA "determines appropriate to enable the producer to receive payments in an efficient, equitable, and expeditious manner so as to ensure that the producer receives the same total return as if the payments had been made in cash."¹⁸⁷ Consistently with Congress's apparent desires, those engaged in agricultural commerce and lending have treated PIK certificates substantially as cash equivalents.¹⁸⁸

In the *O'Briant* case, the debtor's possession of the PIK certificates communicated to the father-in-law the impression that the debtor could freely transfer the PIK certificates.¹⁸⁹ Under those circumstances, security law should provide a negotiability rule to protect the third-party purchaser.¹⁹⁰ Ideally, then, the father-in-law in *O'Briant* should have prevailed—not because the PIK certificates were not proceeds, as some have suggested,¹⁹¹ but because the father-in-law should have taken the certificates free and clear of PCA's security interest.¹⁹²

187. *Id.* § 1445k(b)(4).

188. *In re Halls*, 79 B.R. 417, 421 (Bankr. S.D. Iowa 1987) (recognizing the importance of "the transferability of certificates [in] . . . the regulatory scheme in question" and the development of a market for those certificates); *accord In re George*, 85 B.R. 133, 143-44 (Bankr. D. Kan. 1988) (noting the similarities between PIK certificates and cash), *aff'd*, 119 B.R. 800 (D. Kan. 1990).

189. *Sweetwater Prod. Credit Ass'n v. O'Briant*, 764 S.W.2d 230, 231 (Tex. 1988).

190. While security law should protect a bona fide third party purchaser of PIK certificates against a secured party claiming an interest in the PIK certificates as proceeds, security law would not and should not protect the bankruptcy trustee in the same situation. Under Bankruptcy Code § 544(a), the bankruptcy trustee does not assume the status of a bona fide purchaser of the debtor's assets; instead, the trustee assumes only the status of a lien creditor. *See* 11 U.S.C. § 544(a) (1988). As long as the secured party's interest in proceeds remains perfected under § 9-306(3), the secured party would prevail over the trustee. *See* U.C.C. § 9-301(1)(b) (1990). Thus, in those cases when the debtor files bankruptcy but has not transferred its PIK rights to a third party purchaser, the secured party should have priority in the PIK rights under § 9-306. *E.g., In re Kingsley*, 865 F.2d 975, 979 (8th Cir. 1989).

191. *See supra* note 138 and accompanying text.

192. It is doubtful whether the current language of Article 9 can accomplish this result. One might argue that PIK certificates constitute "instruments" under § 9-105(i) because that term includes not only Article 3 negotiable instruments but also "any other writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment." U.C.C. § 9-105(1)(i) (1990). Certainly, PIK certificates are ordinarily transferred by delivery with a restrictive

2. Business Interruption Insurance Payments as Proceeds of a Debtor's Accounts and General Intangibles

The *ex ante* understanding of Debtor and Secured Party also is relatively clear in business interruption cases. If Secured Party takes a floating lien upon Debtor's accounts and general intangibles, that contract essentially grants Secured Party a lien upon Debtor's business revenues. An objective observer looking at the security agreement would conclude that Debtor and Secured Party understand and expect that Debtor will continue to operate and generate accounts and other intangible rights to which Secured Party's lien will attach. If Debtor carries out this expectation, there is no question about the validity of Secured Party's interest in Debtor's business revenues.

But suppose Debtor cannot carry out this expectation due to some intervening force. This intervening force effectively deprives Secured Party of some portion of the collateral for which it bargained—the future revenues Debtor would have generated but for the interruption. If this loss is uninsured, Secured Party bears the risk of Debtor's insolvency, as would be true if Debtor suffered damage to uninsured *tangible* collateral. If the loss is insured, however, the business interruption case is functionally analogous to the casualty insurance cases discussed in Part II.¹⁹³ The purpose of business interruption

endorsement. See, e.g., 7 C.F.R. § 770.4(c) (1988) (specifying transfer requirements under prior regulations).

The problem, however, is that PIK certificates are not necessarily payable in money, even if they are intended to function essentially as a cash equivalent. As a consequence, most courts have concluded that PIK certificates are either Article 9 "accounts" or "general intangibles." E.g., *In re Schmalzing*, 783 F.2d 680, 683 (7th Cir. 1986); *In re George*, 85 B.R. 133, 145 (Bankr. D. Kan. 1988), *aff'd*, 119 B.R. 800 (D. Kan. 1990); *In re Clark*, 82 B.R. 131, 132-33 (Bankr. D. Colo. 1987); *In re Lion Farms, Inc.*, 54 B.R. 241, 244-45 (Bankr. D. Kan. 1985), *aff'd*, 4 U.C.C. Rep. Serv. 2d (Callaghan) 1212 (D. Kan. 1987); *In re Binning*, 45 B.R. 9, 12 (Bankr. S.D. Ohio 1984); *In re Schmidt*, 38 B.R. 380, 383 (Bankr. D.N.D. 1984); *In re Sunberg*, 35 B.R. 777, 781-82 (Bankr. S.D. Iowa 1983), *aff'd*, 729 F.2d 561 (8th Cir. 1984). Likewise, the *PEB Report* recommended that the Drafting Committee give "serious consideration" to defining government subsidies as general intangibles under § 9-106. *PEB Report*, *supra* note 15, at 182-83.

The result of this classification, however, is that PIK certificates will not fall within the quasi-negotiability rules established in § 9-308 for instruments and chattel paper. If PIK certificates are truly quasi-negotiable collateral, then the Drafting Committee should either revise § 9-105(1)(i) to include them within the definition of instrument, or revise § 9-308 to include PIK certificates within that section's negotiability rule.

193. See *supra* part II.B.1.

insurance is to protect the insured party against a loss of prospective earnings due to a business interruption.¹⁹⁴ As such, business interruption insurance payments are derivative of and a substitute for the accounts and intangibles that Debtor would have generated but for the interruption. Since Secured Party's lien would have covered those accounts and intangible rights directly, security law should treat the insurance moneys as proceeds of Secured Party's collateral.¹⁹⁵

As the United States District Court for the Western District of Missouri recognized in *MNC Commercial Corp. v. Rouse*, applying the nonexistent collateral concept to prevent this result frustrates the *ex ante* bargain of the parties and accords the debtor a windfall.¹⁹⁶ In *MNC Commercial Corp.*, which reversed the bankruptcy court decision in *Kroehler Cabinet*,¹⁹⁷ the court addressed and squarely rejected the nonexistent collateral doctrine:

The Trustee[] argu[es] . . . that the business interruption proceeds did not replace any existing collateral because Kroehler did not continue it's [sic] business, and therefore, lost the ability to generate income. The Trustee's [argument] is without merit. The precise purpose of a Business Interruption Policy is to compensate an insured for lost business income because the insured is unable to produce income from it's [sic] own operations. There is no real distinction between business income generated from normal operations and insurance proceeds paid to replace lost business income under a Business Interruption Policy.¹⁹⁸

MNC Commercial Corp. thus neatly demonstrates how a court should apply Section 9-306(1) in a manner consistent with the U.C.C.'s primary rules of construction and in a fashion consistent with the proper economic conception of the term "proceeds."

194. *Quality Molding Co. v. American Nat'l Fire Ins. Co.*, 272 F.2d 779, 780 (7th Cir. 1959).

195. David B. Young, *The Rights of Secured Creditors to the Proceeds of Business Interruption Insurance Under UCC Article 9*, 26 UCC L.J. 204, 229 (1994) (recognizing that the subject matter of Secured Party's lien in this example would be "identical to the subject matter of the business interruption policy").

196. No. 91-0615-CV-W-2, 1992 WL 674733, at *1 (W.D. Mo. Dec. 15, 1992).

197. 129 B.R. 191 (Bankr. W.D. Mo. 1991), *rev'd sub nom.*, *MNC Commercial Corp. v. Rouse*, No. 91-0615-CV-W-2, 1992 WL 674733 (W.D. Mo. Dec. 15, 1992); *see supra* notes 151-153 and accompanying text. The district court's decision in *MNC Commercial Corp.* has not been published in any official reporter. This lack of publication is remarkable, particularly since the question of whether business interruption insurance payments are proceeds under § 9-306(1) was an issue of first impression in the district courts.

198. *MNC Commercial Corp.*, 1992 WL 674733, at *1 n.3.

IV. SECTION 9-306, CONCEPTUAL COHERENCE, AND THE ARTICLE 9 REVISION PROCESS

This Article has focused thus far upon the existing version of Section 9-306(1) and how courts should interpret its definition of proceeds to carry out the *ex ante* bargain of the reasonable debtor and secured party. The history of the casualty insurance cases discussed in Part II, however, demonstrates that recalcitrant courts often embrace form over substance in interpreting statutes until the legislature expressly codifies the substance.¹⁹⁹ Since Article 9 is currently undergoing revision, the drafters should rewrite Section 9-306 to codify the proper scope of the term “proceeds.” The following subsections identify the issues crucial to the revision process.

A. *The PEB Report and Its Recommendations*

As noted in Part I, a report commissioned by the U.C.C.’s Permanent Editorial Board recommended a systematic revision of Article 9.²⁰⁰ Several of the recommendations in the *PEB Report* attempt to address the proper scope of the term “proceeds.” The *PEB Report* recognized the crabbed judicial interpretations to which courts have subjected Section 9-306(1), noting that “the concepts ‘sale, exchange, collection or other disposition’ found in the current definition may not be broad enough” to demonstrate clearly the proper scope of the term “proceeds.”²⁰¹ The commentary in the *PEB Report*, however, spoke in relatively broad strokes and did not propose specific amendatory language. Further, the commentary did not attempt to establish one unifying concept underlying the true scope of the term “proceeds.” In its discussion, the *PEB Report* separated the universe of proceeds cases into two categories: the “exchange and replacement” cases²⁰² and the “close association” cases.²⁰³

Within the “exchange and replacement” cases, the *PEB Report* placed those transactions in which something is “received in place of

199. See *supra* part II.B.1.

200. See *supra* text accompanying notes 15-16.

201. PEB REPORT, *supra* note 15, at 106.

202. *Id.* at 110-11.

203. *Id.* at 111.

and in substitution for the original collateral, which has been disposed of or reduced in value.”²⁰⁴ Under this paradigm, the *PEB Report* placed the casualty insurance cases, the lease rental cases, cases involving tort claims and breaches of sales contract warranties, and cases involving a debtor’s licensing of intellectual property.²⁰⁵ Consistent with *PEB Commentary Number 9* and its rejection of the *Cleary Brothers* analysis of lease rental payments,²⁰⁶ the *PEB Report* recommended revising Section 9-306(1) to make clear that lease rentals constitute proceeds.²⁰⁷ Likewise, the *PEB Report* acknowledged that tort claims and breach of contract warranty claims “replace[] the value of collateral that would have (or should have) been available to a secured party” and are thus so “similar to insurance proceeds” that Section 9-306(1) should treat them as proceeds of the collateral.²⁰⁸

Within the “close association” paradigm, the *PEB Report* placed cases that it believed did not fit naturally within the exchange and replacement paradigm. Here, the *PEB Report* included cases involving “all forms of distributions on account of securities, partnership interests, . . . government subsidies, and other payments that do not involve an ‘exchange.’”²⁰⁹ In suggesting that these sums constituted proceeds of collateral, the *PEB Report* concluded that they were “so necessarily and obviously associated with an interest in the original collateral that a security agreement and financing statement ought not to be required to mention them explicitly.”²¹⁰ Without suggesting precise amendatory language, the *PEB Report* concluded that Section 9-306(1) should be “revised so as to embrace this ‘close association’ concept.”²¹¹

204. *Id.* at 110.

205. *Id.* at 110-11.

206. *See supra* note 86 and accompanying text.

207. *PEB REPORT*, *supra* note 15, at 110.

208. *Id.* at 110-11. As to a debtor’s licensing of intellectual property, the *PEB Report* took no definitive position; it merely stated that “[t]he Drafting Committee should consider whether to revise the definition to provide that royalties arising out of a debtor’s licensing of intellectual property constitute proceeds of the intellectual property.” *Id.* at 106.

209. *Id.* at 111.

210. *Id.* (“If the debtor, as owner of the collateral, is necessarily entitled to such property, then a secured party likewise should be entitled to the property as collateral.”).

211. *Id.*

B. *Toward a Unitary, Coherent Conception of Proceeds*

By distinguishing between exchange and replacement proceeds and close association proceeds, the *PEB Report* creates the impression that there is no coherent, unified conception that provides a basis for classifying assets as proceeds. As further discussed below, this impression is mistaken. In fact, the *PEB Report's* definition of close association proceeds—"those things that are so necessarily and obviously associated with an interest in the original collateral that a security agreement and financing statement ought not to be required to mention them explicitly"²¹²—encompasses *all* varieties of proceeds.

1. Protecting Against Diminishing the Collateral's Economic Value

In any secured transaction, the debtor and secured party bargain to provide the secured party with a property interest in the debtor's "collateral." But exactly what is the collateral over which the debtor and secured party bargained? As security law concerns itself with interests taken for security purposes, the real subject matter of the secured transaction is the economic value of the collateral. In order to respect the expected *ex ante* bargain of reasonable debtors and secured parties, security law generally should protect secured parties against actions and events that effectively reduce the collateral's economic value.

This proposition is best demonstrated by the normative assumptions underlying Bankruptcy Code sections 361 through 363, which address, among other things, a debtor's obligation to provide the secured party with adequate protection of its security interest.²¹³ Under Section 363(e), a bankruptcy court must prohibit a debtor from using collateral over the secured party's objection unless the debtor can provide adequate protection of the secured party's interest.²¹⁴ If the debtor's actions or the actions of third parties threaten to reduce the economic value of the collateral and the secured party objects, Section 363(e) requires the debtor to provide compensation to the secured

212. *Id.*

213. See 11 U.S.C. §§ 361-363 (1988).

214. *Id.* § 363(e).

party for this reduction.²¹⁵ These normative assumptions also underlie the current version of U.C.C. section 9-306. As discussed in Part II, both the 1972 revision to Section 9-306(1) and the 1987 revision to Section 1-201(37) indicate that proceeds coverage should protect the secured party against acts or events that exhaust the collateral's economic value.²¹⁶

2. Protecting Against Diminishing the Collateral's Productive Capacity

Once the inquiry focuses upon economic value as a key to proceeds classification, one must recognize that a debtor can consume the value of collateral in different ways. The debtor may consume the value of collateral via its own direct use (e.g., Cleary Brothers uses its crane on projects for which it serves as general contractor), by making the collateral available to third parties for their use permanently (e.g., Cleary Brothers sells the crane to a competitor), or by making the collateral available to third parties for their temporary use (e.g., Cleary Brothers leases the crane to another contractor for its use on other sites). Stated differently, the debtor's acquisition of title to the collateral naturally brings with it the collateral's *future productive capacity*, which the debtor captures through using the collateral (either in its own business or by transferring some or all of that use to third parties). In reality, the economic value of business collateral is nothing more than the net present value of what that collateral can produce in the future.²¹⁷ Thus, to the extent that Section 9-306's proceeds coverage protects the secured party against events that exhaust the collateral's

215. See *id.* § 363. This "adequate protection" most likely would take the form of cash payments to account for the expected reduction in value, or a replacement lien upon other unencumbered or underencumbered collateral. See *id.* § 361(1)-(2); see also *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 370 (1988) (concluding that petitioner would be entitled to "cash payments or additional security" for the declining value of an apartment project); EPSTEIN ET AL., *supra* note 57, § 10-5, at 739 ("Adequate protection of a security interest in equipment might include insuring equipment, paying accruing interest or depreciation, and maintaining equipment in good working order.").

216. See *supra* notes 74-81 and accompanying text.

217. Cf. R. Wilson Freyeremuth, *Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance*, 40 UCLA L. REV. 1461, 1501-06, 1532-35 (1993) (stating that the value of commercial real estate development reflects the net present value of its future productive capacity).

economic value, that coverage is incomplete unless it also addresses the exhaustion of the collateral's productive capacity.

This proposition is demonstrated most clearly by the normative assumptions underlying Bankruptcy Code section 552(b):

(1) . . . [I]f the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, or profits of such property, then such security interest extends to such proceeds, product, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law

(2) . . . [I]f the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property . . . , then such security interest extends to such rents . . . acquired by the estate after the commencement of the case to the extent provided in such security agreement²¹⁸

Section 552(b) adopts into bankruptcy law an important normative assumption about the underlying bargain of the reasonable debtor and creditor. Reasonable parties would not expect that the debtor could freely exhaust the value of the collateral by consuming its productive capacity in complete disregard of the secured party's interest. When the Debtor takes, sells, leases, distributes, destroys, foregoes, or otherwise consumes some or all of the collateral or its productive capacity, Section 552(b) takes whatever assets the debtor receives in return and treats them as substitute collateral.²¹⁹ In this fashion, bankruptcy law respects the secured party's economic interest in the collateral.

Within the U.C.C.'s present framework, Section 9-306's proceeds coverage provides the logical conceptual mechanism for dealing with the exhaustion of collateral's productive capacity. Properly characterized, proceeds of collateral include whatever assets the debtor receives as a consequence of the consumption of that collateral's future

218. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 214, 108 Stat. 4106, 4126 (1994) (to be codified at 11 U.S.C. § 552(b)).

219. *Id.*

productive capacity. Such a definition would provide a coherent and unitary framework for classifying proceeds in a manner consistent with the *ex ante* bargain of the reasonable debtor and secured party. Consider the following examples:

- Cleary Brothers acquires a crane. If Cleary Brothers sells the crane to X and passes to X both title and the crane's entire future productive capacity, X's purchase price constitutes proceeds of the crane. If a tornado wrecks the crane (destroying its productive capacity and thus rendering title valueless as an economic matter) and Cleary Brothers collects insurance, that insurance constitutes proceeds of the crane. If Cleary Brothers leases the crane to X, thereby passing to X some or all of the crane's future productive capacity, then the rent payments constitute proceeds.²²⁰
- Hastie acquires 248 shares of FirstBank stock. If FirstBank repurchases 10 shares from Hastie for \$6.20 per share, the \$62 repurchase price constitutes proceeds of the shares. This would remain true even if Hastie paid only \$1 per share for the stock, as the intervening share price appreciation is part of the stock's productive capacity. Likewise, if FirstBank declares a dividend of 25 cents per share, the \$62 cash dividend represents the stock's productive capacity and thus constitutes proceeds of the stock.²²¹
- The Schmalings are farmers. One of their assets is the crop that they have the right to plant during 1994. The Schmalings can take the right to grow and harvest a crop and use that ungrown crop as collateral for a loan from FirstBank. If the Schmalings plant and harvest a bumper crop and sell that crop for cash, the cash represents the productive capacity of the crop and constitutes proceeds of the crop. Alternatively, the Schmalings can transfer their right to plant to a third person (USDA) in exchange for a PIK payment. If the Schmalings take the right to grow and harvest this crop and use that right to acquire a PIK benefit, that PIK benefit reflects the productive capacity of the crop rights that the Schmalings pledged to FirstBank, and thus constitutes proceeds of the ungrown crop.²²²

C. *The Logical Limit of Continuing Proceeds Coverage*

At first blush, one might attempt to criticize this unitary conception of proceeds by suggesting that under such a conception,

220. See *supra* part II.B.1-2; *infra* app., at cmt. 2, ex. 1-2.

221. See *supra* part II.C.1; *infra* app., at cmt. 2, ex. 4.

222. See *supra* part III.B.1; *infra* app., at cmt. 2, ex. 6.

everything becomes proceeds. The *PEB Report* implicitly made this same criticism in attempting to define the logical limit of the term "proceeds":

At some point, the acquisition of assets by a debtor, in part as a result of a diminution in value of collateral, will be too attenuated for those assets to be considered proceeds. For example, accounts generated by a construction contractor should not be considered proceeds of the contractor's construction equipment, even though the equipment depreciates as a result of its use in generating the accounts. Nor should inventory fabricated by a debtor's factory equipment be considered proceeds of that equipment. Cash earned from music or video machines presents a case closer to the margin. Has the equipment merely provided a service, or is the better analogy that of a short-term rental? The Committee is inclined to leave such marginal cases to the courts.²²³

This attempted limitation on the scope of the term "proceeds" is not surprising, as it is fully consistent with earlier statements by the PEB and by leading Article 9 commentators.²²⁴

The *PEB Report's* attempted limitation on the scope of the term "proceeds" misses the mark, however, for two reasons. First, the *PEB Report* fails to explain as an economic matter how these derivative assets are functionally different from other derivative assets, such as sale proceeds and lease rentals, that clearly constitute proceeds. Second, the *PEB Report* confuses the question of *whether to classify an asset as proceeds* with the question of *whether the security interest continues in that asset*.

1. The Functional Similarity of Derivative Assets

One can see the error of the *PEB Report* by considering the very examples it used to attempt to limit the term "proceeds." For example, consider the *PEB Report's* construction contractor

223. PEB REPORT, *supra* note 15, at 111 n.16.

224. See generally PEB COMMENTARY NO. 9, *supra* note 86 (asserting that while lease payments constitute proceeds of leased equipment, "income generated from the debtor's own use and possession of goods should [not] constitute proceeds of a secured party's pre-existing collateral consisting of the goods"); see also BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 6.04[2][d], at 6-78 (1993) ("[I]ncome generated from the debtor's own use of the equipment should not qualify as proceeds, because there has been no 'disposition' of the equipment except in the broad sense of depreciation.").

hypothetical.²²⁵ The contractor can use its equipment to generate rights to payment in several different ways. The contractor can use the equipment by selling it for cash to a third party; alternatively, the contractor can use the equipment by leasing it to a third party. In each case, the use takes some or all of the equipment's productive capacity and exhausts that capacity by devoting it to the benefit of a third party. Accordingly, each corresponding right to payment is an asset that derives from the equipment. Further, there is no functional basis in an economic sense for treating the "sale" moneys as proceeds and the "lease" moneys as nonproceeds. Substantively, each represents a return upon some portion of the equipment's productive capacity. The two situations merely reflect different forms through which the contractor may capture the economic value of the equipment.²²⁶

Likewise, the contractor can use the equipment by leasing it to a third party to use on other jobs, or by using the equipment on its own jobs to produce accounts. In either case, the contractor's use takes some or all of the equipment's productive capacity and exhausts that capacity by devoting it to the benefit of a third party. As a result, each corresponding right to payment from the third party is an asset that derives from the equipment. Again, there exists no functional basis in an economic sense for treating the rents as proceeds and the accounts as nonproceeds. Substantively, these situations merely reflect different forms through which the contractor may capture the economic value of the equipment. Functionally, then, both the accounts and the lease rentals should constitute proceeds of the equipment within the economic, value-based conception of the term.²²⁷

The *PEB Report* is no more persuasive in its video machine hypothetical.²²⁸ As suggested above, there exists no functional basis

225. PEB REPORT, *supra* note 15, at 111 n.16.

226. Freyermuth, *supra* note 217, at 1532-35.

227. One can analyze the *PEB Report's* inventory hypothetical in a similar fashion. The debtor can recover the economic value of its equipment by using that equipment to produce inventory or by selling it to a third party who will use it to produce inventory. In each case, the use consumes a portion of the equipment's productive capacity in the hands of the debtor. Thus, the assets received by the debtor as a consequence of each form of use clearly are derivative of the equipment, and clearly fall within the economic, value-based conception of the term "proceeds." In an economic sense, the inventory generated by the equipment is as much proceeds of the equipment as the rentals that the equipment would generate if leased.

228. PEB REPORT, *supra* note 15, at 111 n.16.

for distinguishing cash generated through the sale of collateral from cash generated through its "use."²²⁹ When the debtor acquires a video game, it acquires title to that machine and the machine's future productive capacity, the stream of cash receipts paid by users of the machine. The debtor might lease the machine to a user for a term, or might instead retain possession of the machine and make it available to invitees or licensees. In either case, the assets received by the debtor in exchange for that use are derivative of the machine; those assets equally constitute the fruits of the machine's productive capacity. As such, those sums properly constitute proceeds of the machine.²³⁰

2. "Identifiability" as the Logical Limit of Proceeds Coverage

a. The Proper Interaction of Sections 9-306(1) and 9-306(2)

The hypotheticals that the *PEB Report* uses to try to limit the scope of the term "proceeds" demonstrate a clear result orientation. The *PEB Report* assumes the correct result—that the secured party in the construction contractor hypothetical should not have a continuing security interest against the contractor's accounts. The

229. See *supra* part II.B.2.

230. The only reported decision addressing the classification of cash produced by video machines is *In re S & J Holding Corp.*, 42 B.R. 249 (Bankr. S.D. Fla. 1984). The *S & J Holding Corp.* court refused to construe § 9-306(1) to include the cash produced by the debtor's video games because, like construction equipment, the cash is generated by the use of the collateral, and not the disposition of it. *Id.* at 250.

The *S & J Holding Corp.* court's analysis provides a personality-based comparison to the current judicial debate concerning whether hotel room revenues are different from apartment rents and revenues of other tenant-based commercial real estate projects. Many bankruptcy courts have distinguished between hotels and apartments, concluding that apartments generate rents (real property collateral) while hotels do not because hotel guests are not tenants. See, e.g., Freyermuth, *supra* note 217, at 1467-76 (analyzing cases in this area). I have argued elsewhere that this distinction is legally and commercially unjustifiable, as the distinction between tenants and licensees has no necessary legal or functional consequence for how security law classifies occupancy fees when those fees are assigned as collateral. *Id.* at 1476-1512.

The *S & J Holding Corp.* court's analysis suffers from comparably unjustifiable formalism. The difference in the quantum of rights possessed by the lessee user of the video machine and the invitee or licensee user of the video machine has no necessary legal or functional consequence for how security law classifies the cash that each user pays for its quantum of rights. In each case, that cash reflects the fruits of the video machine's productive capacity. Just as apartment rents and hotel room revenues properly constitute proceeds of the land, *id.* at 1532-35, video machine income properly constitutes proceeds of the machine.

PEB Report then chooses the most apparent solution that achieves that result—treating the contractor’s accounts as nonproceeds.

The *PEB Report* errs, however, because it fails to recognize that the present language of the U.C.C. already achieves this result without placing a formalistic and commercially unjustified limitation upon the scope of the term “proceeds.” In attempting to limit the scope of the term, the *PEB Report* confuses two unrelated questions: first, *whether to classify an asset as proceeds* and second, *whether the security interest continues in that asset*. As Section 9-306(2) makes clear, these are separate inquiries.²³¹ The fact that an asset constitutes proceeds of collateral does not mean that the secured party automatically takes a continuing security interest in that asset. Depending upon the circumstances, an asset may constitute proceeds of collateral within the economic, value-based conception of that term, and yet a security interest will not continue in that asset because the asset is not *identifiable* proceeds of the collateral under Section 9-306(2).²³²

One can see the coherent interaction of Section 9-306(1) and Section 9-306(2) by again considering the hypotheticals from the *PEB Report*. As demonstrated above,²³³ the contractor’s accounts properly constitute proceeds of the equipment under Section 9-306(1), just as lease rentals would also constitute proceeds of the equipment if the contractor leased the equipment to a third party. Both the accounts and the lease rentals would be assets that are derivative of the equipment, functionally comparable to each other in an economic sense. Therefore, Section 9-306(1) should not distinguish them.

Section 9-306(2), however, should distinguish them. While the secured party would have a continuing security interest in the lease rentals,²³⁴ the secured party would have no continuing security interest in the accounts under Section 9-306(2). When the contractor uses the equipment by leasing it to a third party, there is no substantial question about the secured party’s continuing interest in the lease rentals, which

231. See U.C.C. § 9-306(2) (1990) (“[A] security interest continues in . . . any *identifiable* proceeds . . .” (emphasis added)).

232. See U.C.C. § 9-306(2) (1990) (“Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof . . . and also continues in any *identifiable* proceeds including collections received by the debtor.” (emphasis added)).

233. See *supra* notes 225-227 and accompanying text.

234. See *supra* notes 73-86 and accompanying text.

can be identified *precisely to the lease of the equipment*. When the contractor uses the equipment to generate accounts on its own jobs, however, the accounts are proceeds but cannot be identified precisely to the equipment. While the accounts are proceeds of the equipment, at a minimum they are also proceeds of any materials the contractor used on the job and the contractor's labor and expertise. Since the accounts are not identifiable precisely to the equipment, the secured party's lien should not extend to the accounts under Section 9-306(2).²³⁵

b. A Final Aside: The Logical Limit of the Identifiability Principle

At first blush, one might criticize as unrealistic this Article's assertion that the lease rentals in the *PEB Report* contractor hypothetical are identifiable precisely to the equipment. One might argue that these lease rentals are also received on account of other "services" provided by the contractor. These might include, *inter alia*: (a) the time and expertise of the debtor's customer service employee who leased the equipment to the customer; (b) the

235. A recent bankruptcy decision, *In re Northeastern Copy Servs., Inc.*, 175 B.R. 580 (Bankr. E.D. Pa. 1994), provides another hypothetical to demonstrate the appropriate relationship between Section 9-306(1) and Section 9-306(2). In *Northeastern*, a creditor held a security interest in all of the equipment, machinery, and inventory of the debtor, which ran a copying service. Following the debtor's bankruptcy, the debtor generated over \$20,000 in gross revenues each month on account of providing copy services to its customers. *Northeastern*, 175 B.R. at 582. The creditor argued that these revenues constituted proceeds of its collateral and asked the court to enjoin the debtor from using these revenues without providing adequate protection of the creditor's interest. *Id.* The court rejected the creditor's request, holding that "the cash generated by [the debtor's] performance of post-petition copy services are clearly not 'proceeds'" of the debtor's equipment, machinery, and inventory. *Id.* at 583.

By following the logic expressed in the *PEB Report*, the *Northeastern* decision fails to appreciate the true nature of this debtor's gross revenues and the proper relationship between Section 9-306(1) and Section 9-306(2). Properly understood, revenues for post-petition copy services are proceeds of the debtor's equipment, machinery, and inventory; these revenues reflect the economic value of the debtor's copy machines, toner, and paper consumed through providing services to consumers. Thus, the post petition revenues should constitute proceeds of the collateral under Section 9-306(1). The creditor should not receive a continuing lien upon these revenues. A significant portion of the debtor's post-petition services (and revenues paid for those services) involves the debtor's labor rather than its equipment, machinery, and inventory. Since the creditor cannot identify the post-petition revenues *precisely* to its own collateral alone, the creditor should not receive a continuing lien upon those revenues under Section 9-306(2). Like the *PEB Report*, the *Northeastern* decision thus reaches the right result for the wrong reason.

electricity, water, and other utilities that the debtor uses to keep its equipment leasing business open to the public; (c) the time and expertise of the debtor's employee mechanic who services the equipment before it is leased; or (d) any materials consumed in servicing that equipment before it is leased.

In a pure economic sense, this criticism is correct. Some portion of the lessee's rental payments—a very small portion, perhaps, but some portion nonetheless—is properly allocable to the contractor's services as distinct from the equipment itself. One might call this the “equipment/services” distinction: the lessee of equipment is paying both for the equipment and for the services of the lessor in providing that equipment for lease. Thus, in pure economic terms, one might properly question whether the lease rental is identifiable *precisely* to the equipment.

Analogy to real estate finance law, however, demonstrates that this criticism does not foreclose the use of the identifiability principle as the key to establishing the limit of continuing proceeds coverage under Section 9-306. The equipment/services distinction is similar in character to the “land/services” distinction seen in real estate finance law. Under the common law conception of rent, sums payable by an occupier of land in exchange for the use of the land are classified as “rent” (in the nature of realty), while sums allocable to the landowner's personal services are not properly classified as rent.²³⁶ If real estate finance law took the land/services distinction seriously, it would take every lease rental payment—part of which is properly allocable to use of the land, and part of which is properly allocable to the developer's services—and allocate that payment into its land (rent) and services (nonrent) components.²³⁷

In fact, however, real estate finance law does not take the land/services distinction seriously. Land security law does not allocate the tenant's lease payment into its land and services components.²³⁸

236. See Freyermuth, *supra* note 217, at 1515-17.

237. See *id.* at 1519-20.

238. Several practical obstacles explain why most courts have rejected the land/services distinction altogether in the landlord-tenant context:

The first obstacle concerns the tracking of historical cost data. Even if one assumes that all occupiers equally value the importance of services to their bargains, requiring a land/services allocation would require parties to compile and analyze historical information concerning the developer's capital and operational costs in order to allocate revenue properly into its rent/nonrent components.

Instead, land security law chooses to allocate 100 percent of the tenant's contractual obligation to land, thus treating the land as the predominant aspect of the exchange.²³⁹ Accordingly, land security law treats 100 percent of the tenant's obligation as rent, even though some portion of that obligation is economically allocable to services. Likewise, the U.C.C. ought not take the equipment/services distinction seriously in the equipment leasing hypothetical. In addition to the expense and uncertainty associated with making such allocations, requiring the maintenance of this distinction would be inconsistent with the behavior of the lessor and lessee, who typically do not separate the lessee's payment obligation into a use component and a services component.²⁴⁰

Instead, security law should focus upon whether the user receives a legally protectible right of use in the equipment itself—one that a court would protect by granting damages or specific performance. In the equipment leasing hypothetical, the lessee receives a legally protectible right of use in the equipment in exchange for agreeing to make a rental payment. Rather than allocate that payment between equipment and services, security law should simply deem that payment to be allocated entirely to the equipment. Accordingly, the lease rental would be identifiable precisely to the equipment, and would therefore constitute identifiable proceeds of the equipment under Section 9-306(2).²⁴¹

Complying with this requirement would involve time and expense, with nothing gained save the integrity of the common law's conception of rent as issuing directly from the land. The second and larger obstacle is that all occupiers of a project are not alike. The extent to which different occupiers are concerned about "mere occupation of space" as opposed to "personal services" is a function of each occupier's respective preferences. As an empirical matter, these preferences may be impossible to measure accurately (and may change over time), thus rendering the correctness of any particular allocation open to question.

Id. at 1520.

Most significantly, requiring an allocation would be artificial given the contractual behavior of owners and occupiers of commercial real estate. In making an occupancy agreement such as a lease, the owner and the occupier typically do not separate the occupier's payment obligation into a "use" component and a "services" component; rather, the occupier agrees to make one payment in exchange for all benefits received. *Id.* at 1520-21.

239. *Id.* at 1522.

240. *See supra* note 238.

241. *See* U.C.C. § 9-306(2) (1990).

c. The Benefits of Identifiability as the Key to Continuing Proceeds Coverage

In addition to according the term “proceeds” a unitary, coherent scope, there are two additional justifications for recognizing and treating “identifiability” as the key to establishing the logical limit of proceeds coverage under Section 9-306(2). First, Section 9-306(2)’s limitation of proceeds coverage to “identifiable” proceeds achieves a result that roughly yet accurately reflects the expected *ex ante* bargain of the reasonable debtor and secured party. Again, this becomes apparent when one considers the *PEB Report’s* contractor hypothetical.²⁴² If the contractor grants the secured party an interest only in its equipment, a reasonable third person looking at the security agreement would extrapolate the following *ex ante* bargain:

- On the one hand, if the contractor uses the equipment by selling it or leasing it to third parties for their consumption, one would expect reasonable persons in the positions of the debtor and secured party to understand that the secured party’s lien would continue against the sale/lease payments. Since those payments are traceable only to the equipment, one cannot confuse them with other inputs over which the parties do not appear to have bargained in the security agreement. Thus, one can conclude that the parties understand that those payments would stand in place of the collateral.
- On the other hand, if the contractor uses the equipment to generate accounts on its own construction jobs, no reasonable person in the position of the secured party could expect its lien to continue against those accounts. The accounts do not flow solely from the equipment, but also from other inputs (labor, raw materials, etc.) over which the parties do not appear to have bargained. Thus, one cannot conclude that the parties would understand that those accounts would stand in place of the collateral. The parties’ failure to anticipate and deal with the tracing problem, which they might have done by including accounts as part of the collateral, reflects their apparent understanding that the secured party should have no continuing lien upon the debtor’s accounts.

In contrast, if the contractor granted the secured party an interest in both equipment and accounts, one would look at the security agreement and extrapolate a different bargain. This security agreement, which expressly describes both the original collateral and

242. See PEB REPORT, *supra* note 15, at 111 n.16.

what it produces, manifests the parties' mutual understanding that the secured party is to have a lien upon the accounts even though they are not identifiable proceeds of the equipment automatically covered by Section 9-306(2).²⁴³

Second, focusing upon Section 9-306(2)'s identifiability requirement as the appropriate logical limit of proceeds coverage will result in more coherent judicial decision-making than exists at present, when courts focus purely upon the interpretation of the statutory term "proceeds" under Section 9-306(1).²⁴⁴ If the Drafting Committee adopts the economic, value-based conception of proceeds advocated here, one can expect a drastic reduction in litigation over the *legal* issue of the scope of the term "proceeds" under Section 9-306(1). Thereafter, proceeds litigation would instead focus upon a *factual* issue that should be relatively easy to determine: whether the proceeds were identifiable under Section 9-306(2). In contrast, if the Drafting Committee duplicates the error of the *PEB Report* and places a conceptually unjustified restriction on the definition of "proceeds," one can expect continued litigation over the legal issue of the scope of the term "proceeds." By articulating a conception of proceeds that is internally incoherent, the Drafting Committee would send a signal to courts that the term "proceeds" is nebulous enough as a matter of law to justify any particular result. Given the historical frequency with

243. The *PEB Report's* inventory fabricator example can be analyzed in a similar fashion. *Id.* If the debtor leased the equipment to a third party, the secured party would obtain a continuing security interest in the rent payments, which are identifiable precisely to the lease. If the debtor uses the equipment to fabricate its own inventory, however, that inventory is not identifiable precisely to the equipment. At a minimum, the inventory is also identifiable to the debtor's raw materials and labor.

Thus, if the debtor had granted the secured party an interest only in its equipment, the expected *ex ante* bargain of the hypothetical reasonable debtor and secured party is clear. One looking at such a security agreement would conclude that the parties understood that the secured party would have no lien against the inventory, which represents a return upon other inputs over which the parties do not appear to have bargained. Therefore, the secured party would not receive a security interest in the inventory under § 9-306.

The *PEB Report's* video machine example likewise poses no problems under § 9-306(2). Cash generated by use of a video machine would be identifiable precisely to the machine; thus, the secured party's lien upon the machine would continue into the cash proceeds under § 9-306(2). A different result would follow, however, if the collateral were a vending machine. In that case, cash generated by the machine would not be identifiable precisely to the machine, but also to the items distributed by the machine. As a result, a secured party with a lien solely upon the vending machine would have no continuing lien upon the cash generated from that machine.

244. See *supra* notes 1-14 and accompanying text.

which courts have used formalistic interpretations of Section 9-306 to reach particular results,²⁴⁵ that would be a poor message to send.

V. CONCLUSION: A PROPOSAL FOR REVISING SECTION 9-306 AND ACCOMPANYING COMMENTARY

The conception of proceeds presented in this Article is the only conception that is sufficiently coherent to rescue the term from the morass of ambiguity caused by judicial decisions focusing upon the passage of title and nonexistent collateral distracters. To give the term “proceeds” a coherent, functional meaning, one must define that term to include all assets received upon the occurrence of events that exhaust the collateral’s economic value or productive capacity. At the same time, Article 9 should extend continuing proceeds coverage no further than those proceeds that are identifiable precisely to the secured party’s collateral. This conception of the term “proceeds” most closely approximates the expected *ex ante* bargain of the reasonable debtor and secured party, and thus should form the basis for any revision of Section 9-306.

As the Drafting Committee undertakes revision of Section 9-306, it should remember the lessons taught by the past thirty years of judicial interpretation of Section 9-306. When combined with the U.C.C.’s rules of construction, the language of the current Section 9-306(1) is sufficient to give the term “proceeds” the economic, value-based meaning advocated in this Article. Nevertheless, courts repeatedly have demonstrated either the incapacity or unwillingness to interpret Section 9-306(1) broadly and consistently with this emerging, economic conception of the term “proceeds.” Because Section 9-306 has always left unspoken the policies underlying this conception, courts have tended to interpret Section 9-306(1) narrowly, forgetting that Section 9-306 is part of a uniform code of commercial law intended to “make distinctions, where distinctions are necessary, along functional rather than formal lines.”²⁴⁶ In revising Section 9-306(1), the Drafting Committee must consider the possibility that the morass of conflicting proceeds decisions resulted from a definition of proceeds that was too subtle and left too much unsaid.

245. See *supra* part III.B.

246. U.C.C. § 9-101 cmt. (1990).

Furthermore, the Drafting Committee should take care not to enact a mere ad hoc revision that overrules aberrant decisions such as *Hastie*, *Schmalzing*, and *Kroehler Cabinet* without overtly articulating a coherent conception of the term "proceeds." Such an ad hoc approach would repeat the mistake of the drafters in the 1972 revision concerning casualty insurance payments. In that revision, the drafters added specific language that reversed the "casualty insurance payments are not proceeds" cases.²⁴⁷ The amending language, however, left unspoken the revision's true rationale—that casualty insurance payments were a substitute for the collateral's economic value and thus properly constituted proceeds of the collateral. At the time, commentators criticized the amendment on this basis, arguing that it should have addressed whether proceeds included similar assets such as tort claims.²⁴⁸ Subsequent history proves that these criticisms were justified. As Parts II and III of this Article demonstrate, the drafters' refusal to articulate overtly the economic underpinnings of the term "proceeds" resulted in an abundance of conflicting decisions and greater ambiguity over the true scope of the term.

To prevent further confusion and inconsistency in judicial interpretation, the Drafting Committee should revise Section 9-306 and its commentary in a manner that leaves no question about the proper scope of the term "proceeds." The following Appendix contains proposed statutory language and commentary for Section 9-306 that would codify effectively both the proper scope of the term "proceeds" and the appropriate logical limit of the secured party's continuing coverage against proceeds.²⁴⁹ This proposed statutory

247. See *supra* note 74 and accompanying text.

248. See, e.g., Henry J. Boroff, *Insurance Proceeds Under Section 9-306: Before and After*, 79 COM. L.J. 442, 443-45 (1974); Hawkland, *supra* note 4, at 12-13. At the time, Boroff presciently noted that the amendment's ambiguity would lead to uncertainty and formalistic judicial interpretation with reliance on the common law. Boroff, *supra*, at 444-45.

Given this history, one can sincerely question the *PEB Report's* apparent willingness to "leave . . . marginal cases to the courts." PEB REPORT, *supra* note 15, at 111 n.16. Unless the revision produces a coherent, functional conception of the term "proceeds" and strong interpretive directions, then leaving marginal cases to the courts can be expected to result in business as usual in the bankruptcy courts—wildly divergent results and no predictability in § 9-306's interpretation.

249. The suggested statutory text and commentary in the Appendix addresses only the changes necessary in the current U.C.C. §§ 9-306(1) and 9-306(2), such as proper classification of an asset as proceeds and the continuation of the secured party's interest in the original collateral and identifiable proceeds. Other issues covered by the current version

language and commentary forms an appropriate basis for the Drafting Committee's consideration as it undertakes revision of Section 9-306.

of § 9-306, such as perfection of a security interest in proceeds and whether § 9-306(2) should incorporate the "lowest intermediate balance rule" for tracing proceeds, are beyond the scope of this Article. For the *PEB Report's* recommendations on these and other issues concerning § 9-306, see PEB REPORT, *supra* note 15, at 112-34.

APPENDIX

Proposed Statutory Language

§ 9-306. "PROCEEDS"; SECURED PARTY'S RIGHTS ON DISPOSITION OF COLLATERAL

- (1) "Proceeds" includes, but is not limited to
 - (a) whatever is received upon the sale, exchange, collection, or other disposition of collateral or proceeds; and
 - (b) any rents, profits, products or offspring of collateral or proceeds.

For purposes of this section, "other disposition" includes any act or event that damages the collateral or reduces its value, even if the debtor retains title to the collateral. Money, checks, deposit accounts, and the like are "cash proceeds." All other proceeds are "non-cash proceeds."

(2) Except where this Article or the security agreement otherwise provides, a security interest continues in collateral notwithstanding sale, exchange, or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections.

OFFICIAL COMMENTS

1. This section states a secured party's right to the proceeds received by a debtor on disposition of collateral and states when his interest in such proceeds is perfected. As provided in Section 9-203(3), a secured party's claim to proceeds under this section does not require a statement in the security agreement; it is assumed that the parties intend for the secured party to retain an interest in proceeds of the collateral unless the parties agree otherwise. Subsection (2) thus carries out the presumed intention of the parties that the secured party should obtain a continuing security interest against proceeds of the collateral as long as the proceeds are identifiable precisely to the collateral.

2. Subsection (1) provides a functional definition of the term “proceeds” that focuses upon economics. Properly understood, “proceeds” includes any asset received upon the occurrence of some event that consumes or exhausts some or all of the economic value or the productive capacity of the secured party’s bargained-for collateral. Prior to this amendment, subsection (1) provided that “proceeds” included “whatever is received upon the sale, exchange, collection, or other disposition of collateral or proceeds.” Had courts interpreted the prior definition broadly as directed by the rules of construction set forth in Section 1-102, amendment to Subsection (1) might have been avoided. Many courts, however, construed the prior definition narrowly, concluding that an asset could not constitute “proceeds” unless the debtor permanently had transferred title to the collateral. *See, e.g., In re Hastie*, 2 F.3d 1042 (10th Cir. 1993) (holding that cash dividends are not proceeds of stock); *In re Cleary Bros. Constr. Co.*, 9 B.R. 40 (Bankr. S.D. Fla. 1980) (holding that equipment lease rentals are not proceeds of equipment);

By construing the prior definition of “proceeds” narrowly and in a formalistic fashion, courts tended to reach results contrary to the presumed bargain of the reasonable debtor and secured party. As amended, subsection (1) expressly rejects the notion that passage of title to collateral is relevant to or determinative of the proper characterization of an asset as “proceeds.” Instead, the definition in subsection (1) focuses squarely upon economics—any asset derived from the consumption or exhaustion of some portion of the collateral’s economic value or productive capacity is “proceeds.”

The operation of this subsection is illustrated by the following examples:

EXAMPLE 1. A obtains a duly perfected security interest in B’s machine, which is insured against casualty by C. B’s machine is destroyed, and C pays \$500 to B pursuant to its obligations under the terms of the casualty policy. The \$500 is a substitute for the economic value of the collateral that was consumed by the casualty. Accordingly, the \$500 constitutes proceeds of the machine.

EXAMPLE 2. A obtains a duly perfected security interest in B’s machine. B leases the machine to C for one year at a rental of \$500/month. B’s action of leasing the machine to C has the effect of consuming a portion of the machine’s productive capacity; the

\$500/month rental is a substitute that *B* receives for transferring the machine's productive capacity to *C*. Accordingly, the \$500/month rental constitutes proceeds of the machine.

EXAMPLE 3. *A* obtains a duly perfected security interest in *B*'s machine. *B*'s machine is destroyed by the negligent actions of *C*. *B* sues *C* in tort and *C* agrees to pay *B* \$500 in settlement of *B*'s claim. The \$500 is a substitute for the economic value of the collateral that was consumed by *C*'s negligent action. Accordingly, the \$500 constitutes proceeds of the machine.

EXAMPLE 4. *A* obtains a duly perfected security interest in 50 shares of ABC Co. stock owned by *B*. ABC Co. declares and pays a cash dividend of \$1/share. The \$50 received by *B* represents a return upon the productive capacity of the 50 shares of stock pledged to *A* as collateral. Accordingly, the \$50 cash dividend constitutes proceeds of the stock.

EXAMPLE 5. *A* obtains a duly perfected security interest in data processing software written by *B*. *B* grants to *C* a nonexclusive site license for the software for a one-time fee of \$500. The \$500 received by *B* represents a return upon the productive capacity of the software pledged to *A* as collateral. Accordingly, the \$500 constitutes proceeds of the software.

EXAMPLE 6. *B* grants *A* a security interest in her yet-to-be-planted alfalfa crop. *A* files a financing statement in all offices required by Section 9-401 to perfect that security interest. Before planting her alfalfa crop, *B* contracts for and receives a \$20,000 agricultural subsidy payment from a government agricultural agency in exchange for her agreement not to plant alfalfa. The \$20,000 is a substitute for the economic value of the crop that was expected to be grown pursuant to the security agreement. Accordingly, the \$20,000 agricultural subsidy payment constitutes proceeds of *B*'s crops even though such crops were never planted.

EXAMPLE 7. *A* obtains a duly perfected security interest in all of *B*'s accounts and general intangibles, now existing and after-acquired. *B* maintains a policy of business interruption insurance, issued by *C*, that protects *B*'s expected business income in the event of a business interruption. An unexpected flood interrupts *B*'s business for a period of nine months. *C* pays \$100,000 to *B* pursuant its obligations under the terms of the business interruption policy. Assuming that the \$100,000 was calculated on the basis of the revenue lost by *B* because

of the flood, the \$100,000 is a substitute for the economic value of the accounts and intangible rights that *B* would have generated absent the flood. Accordingly, the \$100,000 would constitute proceeds of *B*'s accounts and general intangibles.

Examples 6 and 7 demonstrate and reinforce that when attempting to classify an asset as "proceeds," courts should look to the understanding of the reasonable debtor and secured party as manifested in the security agreement. Prior to this amendment, courts often concluded that an asset could not constitute "proceeds" if the bargained-for collateral never came into actual existence. *See, e.g., In re Schmalings*, 783 F.2d 680 (7th Cir. 1986) (holding that federal agricultural payment-in-kind subsidies are not proceeds of crop when debtor never planted a crop); *In re Kroehler Cabinet Co.*, 129 B.R. 191 (Bankr. W.D. Mo. 1991) (holding that business interruption insurance payments are not proceeds of debtor's accounts; accounts never came into existence due to interruption of business), *rev'd sub nom.*, *MNC Commercial Corp. v. Rouse*, No. 91-0615-CV-W-2, 1992 WL 674733 (W.D. Mo. Dec. 15, 1992). Examples 5 and 6 reflect that as amended, subsection (1) rejects these cases in favor of a definition that focuses upon the apparent *ex ante* understanding of the reasonable debtor and secured party.

3. While subsection (1)'s definition of "proceeds" is broad and all-inclusive, subsection (2) states an affirmative limitation upon the ability of the secured party to obtain continuing proceeds coverage under this Section. Before a secured party may obtain a continuing interest upon proceeds, the secured party must demonstrate that those proceeds are *identifiable* precisely to the collateral. The identifiability requirement enables this Section to achieve a result that roughly yet accurately reflects the expected understanding of the reasonable debtor and secured party. When an asset constitutes proceeds under subsection (1) and is identifiable precisely to the collateral, a reasonable debtor and secured party would expect that the secured party would retain an interest upon the proceeds. When an asset constitutes proceeds under subsection (1), but cannot be identifiable precisely to the collateral, a reasonable secured party could not expect to retain a security interest upon the proceeds solely by virtue of this Section.

The operation of this Section is further illustrated by the following examples:

EXAMPLE 8. *A* obtains a duly perfected security interest in *B*'s machine. *B* leases the machine to *C* for one year at a rental of \$500/month. As shown in example 2 above, the \$500/month rental constitutes proceeds of the machine. Since the \$500/month rental is identifiable precisely to machine, *A* obtains a continuing security interest upon the \$500/month rental under subsection (2).

EXAMPLE 9. *A* obtains a duly perfected security interest upon *B*'s equipment. *B* uses the equipment and other raw materials to fabricate inventory. The inventory is received by *B* as the end product of an event that consumes a portion of the equipment's productive capacity. Accordingly, the inventory constitutes proceeds of the equipment under the broad definition established in subsection (1). The inventory is not identifiable precisely to the equipment, however, as it is also a product of the debtor's raw materials and the debtor's labor, neither of which constitute a portion of the bargained-for collateral. Accordingly, even though the inventory may constitute proceeds of the equipment, *A* does not obtain a continuing security interest against the equipment under subsection (2).

EXAMPLE 10. *A* obtains a duly perfected security interest upon *B*'s dairy cattle. *B* chooses to abandon its dairy business and accepts a \$150,000 subsidy payment under a government-sponsored dairy termination program. Assume that a portion of the \$150,000 reflects the slaughter value of the dairy cattle, while the remainder reflects the goodwill and going concern value of *B*'s dairy business. If *A* can demonstrate precisely the portion of the subsidy payment that is allocable to the cattle, that portion of the subsidy payment constitutes identifiable proceeds of the cattle against which *A* obtains a continuing security interest under subsection (2). If *A* cannot demonstrate precisely the portion of the subsidy payment that is allocable to the cattle, then even though some portion of that subsidy payment may constitute proceeds of the collateral, *A* would not receive a continuing security interest against any portion of the subsidy payment under subsection (2).

Example 10 demonstrates that subsection (2) places the burden of proof of identifiability upon the secured party.